SEVERN
TRENT
WATER

Consultation on the Ofwat PR14 reconciliation rulebook

Severn Trent Water response

7 May 2015

Summary of our response

We welcome the opportunity to comment on Ofwat's PR14 reconciliation rulebook. Our views are summarised below, followed by our detailed response to the issues raised.

Given the highly technical, and complex nature of the calculations involved it is almost inevitable that there will be some omissions and some areas where respondents believe an alternative treatment is more appropriate. We address our concerns with specific points within our response, and highlight key issues below.

The biggest issue within this consultation is the proposed CIS adjustment to RCV in relation to the inflation included in the PR09 calculation. We fundamentally disagree with Ofwat's position and also do not consider that the proposed adjustment should be part of the PR14 Rulebook, as this relates to a legacy PR09 issue, and therefore we have set this issue out, separately, in section B of this document.

Ofwat's approach

We support the overall aim of the rulebook, which is to provide companies and other stakeholders with clarity on the way in which PR14 mechanisms will operate during AMP6. We think it is important for companies to understand the way that incentives work if they are to respond to them.

Ideally, the operation of regulatory mechanisms should be laid out before companies accept a Final Determination (FD) – this would represent best regulatory practice. But the publication of the Draft Rulebook shortly after the FD is a significant step forward from PR09, when the details of legacy mechanisms were still being finalised in late 2014.

We are also pleased that Ofwat has presented the Rulebook in the form of a consultation. The detail of these rules can potentially change the deal that companies believed they had signed up to in Final Determinations. Presenting the rules as the completed article without giving an opportunity to appeal would be unreasonable, so it is helpful that Ofwat is open to alternative approaches.

It is helpful that Ofwat has framed its assessment of the options around its statutory duties. We think this is the right approach and agree that the criteria – such as customer benefits, financeability and avoiding perverse incentives – are the right ones. And we think that there are many areas – such as the comparison of actual totex against FD assumptions – where Ofwat's conclusions are reasonable.

Our concerns

Other than the PR09, CIS adjustment, which we address separately, there are five key issues that we raise in relation to the items included in the draft PR14 rulebook. These are overarching points which do not relate to one particular mechanism, but rather the overall approach and criteria used by Ofwat throughout its consultation document.

These five areas are:

- The assessment criteria in relation to Ofwat's duty to ensure companies are financeable. We disagree with the approach to consider financeability before

incentives. Whilst we understand why this was appropriate in previous regulatory periods, we think this needs to be reviewed in light of the current regulatory framework. We have suggested some alternative approaches in our response.
- We feel the application of the assessment criteria in relation to perverse incentives, has not been given sufficient consideration (particularly in light of the first point).
- The definition of ‘incentives’ which includes what are essentially true-ups confuses the picture and may lead to companies facing penalties and financeability challenges for things outside of their control.
- The application of the assessment criteria in relation to consistency has been given insufficient weighting, resulting in a selection of treatments that appears unbalanced towards penalising companies.
- The inclusion of a triviality test for the 2014/15 blind year is unnecessary, and adds complexity.

In addition, there are six key issues that we raise in relation to items Ofwat has not included in the draft PR14 rulebook. Unlike the issues above, these either relate to a mechanism which we consider should be part of the rulebook but, as yet, are not included or part of an existing mechanism which we feel needs further consideration and would benefit from further clarity.

These six issues are:
- The calculation of the shadow RCV, which is not referred to in the consultation, and needs to be understood in time for annual reporting in 2016.
- The RPI used in reaching the opening nominal values in the WRFIM remains undefined, and it is not clear which revenue items are included within the cap.
- Adjustments in relation to NHH revenue which have not been covered in the consultation.
- The treatment of land sales, which impacts the shadow RCV and where the approach at PR14 showed perhaps the greatest inconsistency with other mechanisms.
- The SIM, which the Rulebook covers only in the most general terms.
- Clarity on IDOKs. We recognise that this is not necessarily a rulebook issue as there have not been specific license changes but we would welcome some clarification of how this will work in the AMP6 regulatory framework.

Yours sincerely,

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SEVERN TRENT WATER

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Part A looks to address all areas covered by the rulebook with the exception of the PR09 legacy CIS model reconciliation.

Part B will focus exclusively on the PR09 legacy CIS model reconciliation.

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Part A: PR14 rulebook response

Section A1 Introduction

We welcome this consultation on the PR14 rulebook and consider this to be a positive step forward in creating a fairer and more transparent price review process, as well as helping companies to reduce the regulatory burden at the end of each AMP by setting clear mechanisms in advance.

We also welcome the publication of the draft models, which give companies the opportunity to test the mechanisms and identify any calculation errors or unforeseen consequences of a particular methodology.

Given the highly technical and complex nature of the calculations involved it is almost inevitable that there will be some omissions and some areas where respondents believe an alternative treatment is more appropriate. We have considered our response in light of Ofwat's criteria and where we disagree have explained this with reference to those criteria and statutory duties as set out by Ofwat.

We do not consider that the proposed adjustment to the RCV via the CIS mechanism is part of the PR14 Rulebook, as this relates to a legacy PR09 issue, and therefore we have set this issue out, separately, in section B of this document.

As outlined previously, we set out within this section the key issues from the PR14 rulebook as well as the key omissions from the current proposals. After this we include further detail on all areas of the rulebook, explaining in detail why we agree or disagree with Ofwat's proposed options, and our suggested alternatives where appropriate.

Section A2 Key issues

There are five key issues that we raise in relation to the items included in the draft PR14 rulebook. These are overarching points which do not relate to one particular mechanism, but rather the overall approach and criteria used by Ofwat throughout its consultation document.

These five areas are:

- The assessment criteria in relation to Ofwat's duty to ensure companies are financeable.
- The application of the assessment criteria in relation to perverse incentives.
- The definition of 'incentives' which includes what are essentially true-ups.
- The application of the assessment criteria in relation to consistency.
- The inclusion of a triviality test.

Each of the above are explained below, and in addition we refer to these in later sections where we pick out specific examples of the potential impacts within each mechanism.

Assessment criteria - Duty to finance

It is helpful that Ofwat has framed its assessment of the options around its statutory duties. We think this is the right approach and agree that the criteria – such as customer benefits, financeability and avoiding perverse incentives – are the right ones.

Unfortunately, we do not think Ofwat has applied these criteria properly. On page 2, the consultation assumes that the approach to financeability at PR19, as at PR14, will not take account of the impact of incentives. This effectively means that Ofwat's "duty to finance" is not considered at all. Following this decision, the question simply drops out of the consultation – although "company financeability" appears as a consideration, all options are assessed as green; no other result is possible.

A further problem with this assessment is that it defines the financeability question only in light of Ofwat's modelling at the next periodic review. It does not consider what the impact of changes in methodology might have on companies' financial position during AMP6. Under Ofwat's new reporting guidance, companies will be required to publish their shadow RCV and the rule book mechanisms will have a direct impact on the way the shadow RCV is calculated.

If there is transparent reporting of company performance and incentives earned in period, then investors and other stakeholders' reaction will not be delayed until PR19 – even for rewards and penalties that are not taken in period. Companies may also feel the effects before changes in revenue or the RCV are implemented – in extreme cases this could cause early changes to credit ratings or even lead to a dividend lock-up.

Therefore we do not agree that all financeability issues are 'green' and hence we believe that the financeability criteria have not been adequately considered in the consultation.

As we explain in section A3.1 below, we think that the calculation of the shadow RCV is a key consideration and we are surprised that it is not covered within the consultation.

Assessment criteria - Perverse incentives

The failure to consider the impact on company financing has knock-on consequences for the proper consideration of other criteria – particularly the potential for perverse incentives.

Efficient companies which outperform will receive a negative adjustment to future revenues in AMP7 to reflect the sharing of totex savings with customers. These adjustments could be very large. It creates the perverse incentive to "*not be too efficient as that makes you unfinanceable in the future*". In our view **it would be perverse for an efficient company to be made unfinanceable**. If this policy is not reconsidered, it could change the way that companies behave in AMP6.

To avoid an adverse impact on future credit ratings, a rational approach would be to avoid totex outperformance - for example, by reinvesting any savings made to improve ODI performance.

These perverse incentives, in turn, mean that the question of customer benefit has also not been considered fully. Under this approach it would be more beneficial for companies to pursue ODI performance, even where customers would value future bill reductions above such improvements and would benefit from companies pushing the totex efficiency frontier.

True ups and incentives

Given that Ofwat is re-examining many areas of its framework, we think it is time to consider whether the two-stage approach to financeability is still appropriate.

The original purpose of this policy was to avoid reversing regulatory penalties because of financeability concerns. The approach was developed when Ofwat's policy response to cash flow problems was to provide additional revenue (an NPV positive change). This is no longer relevant. Ofwat's response to such issues would (at most) be to increase the company's PAYG rate. This is an NPV neutral response that only affects the point in time at which revenue is received.

If the two-stage approach is continued then - at the very least - we think that Ofwat needs to look at what these adjustments represent. Some elements *are* incentives (such as ODIs), but others are not. For example, revenue corrections are part of the form of the control – only the penalty for a forecast outside the 2% tolerance can be considered as an incentive. The sharing of totex performance with customers could also be viewed as a true-up; the company's incentive is the element that it has already received (the benefit that flows to the company through saving costs in AMP6).

Therefore, as a principle, these true-up elements should be included before any financeability assessment is made.

Consistency

In our view, the approach to incentives should be consistent with the Final Determination, between different incentives and between companies. Ofwat's preferred options do not imply a consistent approach. For example, the impact of tax, inflation and the time value of money is considered when calculating some adjustments but not for others.

As well as being inconsistent between incentives, we don't think this implies fair treatment for all companies. Since we have in-period ODIs, the impact on us will be lower than for companies that take their rewards or penalties at the end of period. This means we stand to gain or lose more just because of timing. But we do not think this is the correct approach and is potentially against the interest of customers because – in the case of a penalty – customers will receive a lower adjustment to future revenues than they should.

We think that if the economic principle is right, then it ought to be right for all incentives – revenue correction, totex, ODIs and the retail "wash-up". The arguments for a selective application are not convincing.

Triviality

We do not see the need for a triviality limit for legacy adjustments and we do not think it offers any benefits in terms of simplification.

The concept of a triviality threshold is reasonable when applied to relevant changes for an Interim Determination (IDoK) or the old logging up process. It helps to keep the number of changes that need to be considered down to a manageable level. In an IDoK it can potentially help with the problem of information asymmetry: there are a great many changes that will have an effect on company costs or revenues between reviews; companies are better placed to know of these and are more likely to report adverse impacts than favourable changes.

These factors do not apply to legacy adjustments. There are a limited number of mechanisms that can adjust future revenues or the RCV and they have all been laid out by Ofwat in its Final Determination. Once the process for calculating the impact is confirmed, recalculating them is mechanical.

If a triviality threshold was applied, the same calculations would still have to be performed whether the adjustments are included or not. Therefore we think that **a triviality limit would, if anything, make the process more complicated.**

Conclusion

In summary we believe further consideration of financeability assessment is required by Ofwat. We believe the current consultation position does not fully meet Ofwat's statutory duties and there are consequences for the calculations, particularly in relation to perverse incentives.

Section A3 Key omissions from the rulebook

There are six key issues that we raise in relation to the items Ofwat have not included in the draft PR14 rulebook. Unlike section 1.2 above, these each relate to one particular mechanism which we consider should be part of the rulebook but, as yet, are not included or an area of an existing mechanism we feel needs further consideration.

These six items are:

- The calculation of the shadow RCV.
- The RPI used in the WRFIM and definition of revenue that is included.
- Adjustments in relation to NHH revenue.
- Treatment of Land sales.
- The SIM, which the Rulebook covers only in the most general terms.
- Clarity on the IDOK procedure. We recognise that this is not necessarily a rulebook issue as there have not been specific license changes; but we would welcome some clarification of how IDoKs work in the AMP6 regulatory framework.

Each of the above are explained below, and in addition we refer to these in later sections where relevant.

A3.1 Shadow RCV (RCV*)

SVT position:

- We will be required to publish the shadow RCV in the annual regulatory report. As the shadow RCV will be in the public domain for the first time it will have a significant impact on investor and analysts' appraisals of company's value and performance. Any changes in the calculation methodology emerging through the PR19 control could impact market confidence in the sector.

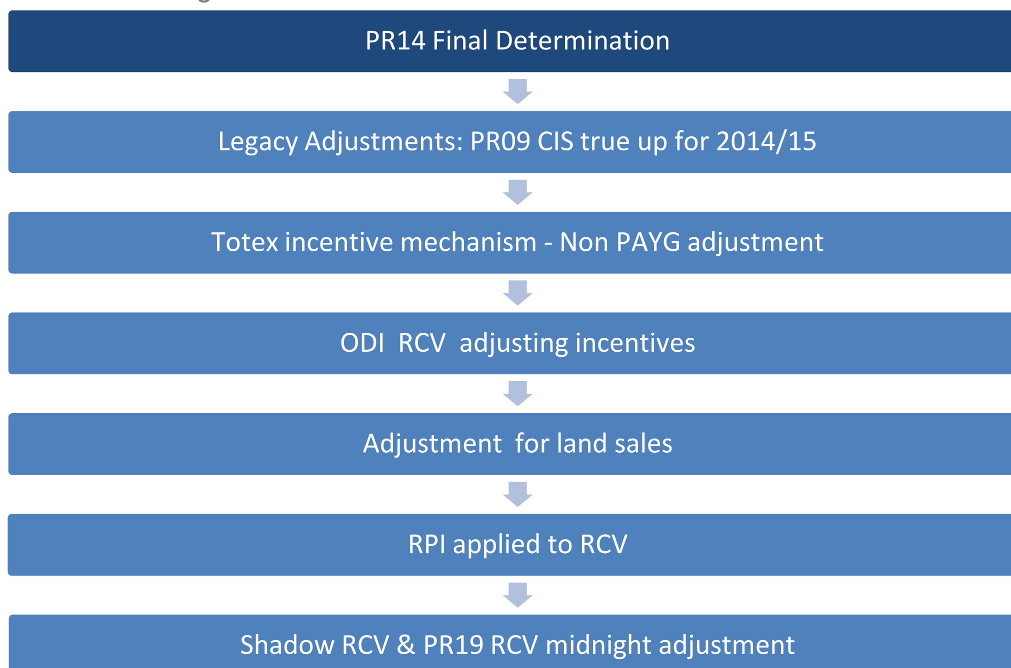
- We would like the rulebook to clearly outline the incentive mechanisms including the calculation methodology and options so there is complete transparency at the beginning of AMP6 rather than time pressured development or changes through the PR19 process. This would ensure consistency of reporting across companies and simplify the PR19 review.

- Although we fundamentally disagree with the adjustment to RCV via the CIS mechanism, should this stand, this would also need to be factored into the shadow RCV. There should be clear rules as to how this is done, and whether a 'Shadow RCV*' is reported which includes the impact, separately from the main shadow RCV. We discuss this issue in Part B.

The Ofgem transmission and distribution RIIO financial model included the future incentive calculation. We feel this holds real value as not only is the incentive mechanism 100% transparent but it was fully understood at the time of signing up to the Final Determination.

A3.1.1 Components of calculation the shadow RCV

The diagram below outlines our view of the components of the calculation of the RCV where we would like clear guidance. We look at each in turn in the remainder of this section.



We feel the PR14 rule book should set out the detail of these calculations (ideally in a published financial model or feeder model). Where possible the performance should be agreed in year e.g. the 2014/15 CIS true up is agreed in 2015/16 off the back of the regulatory report (subject to assurance at final PR19). This would reduce the analytical burden at PR19 and spread the workload throughout the AMP period.

Our view is that each incentive calculation should be considered in isolation to ensure the correct incentive rate is applied. For example, any revenue adjustments for PR09 CIS true up and the PR14 totex incentive calculation are performed separately and the RCV impacts are picked up later in the calculation on PR19 RCV. This will also ensure that each incentive can be treated appropriately in the financeability assessment.

A3.1.2 Legacy Adjustments PR09 CIS true up 2014/15

We recommend using the existing feeder model, updating only for the change in expenditure during 2014/15.

A3.1.3 Totex adjustment to RCV

Indexation of totex

We are supportive of the proposal on the true up methodology between allowed and actual totex (See section A4.2), i.e. allowed totex left in 12/13 prices and actual totex deflated using actual RPI. We would like the PR14 rule book to be explicit on this proposal including the calculation basis for actual RPI i.e. stating that it is year average RPI.

True-up for actual expenditure

In our view, the RCV should be adjusted for:

- The real difference between allowed "capex" and actual; and
- The capitalised portion of incentives.

By "capex" we mean the proportion of the allowance that was capitalised in the Final Determination. We would apply the same annual PAYG rate to actual expenditure for the purpose of the comparison.

We see no benefit in averaging the PAYG rate across the AMP. This would simply distort incentives and the true-up; for example, a company that had spent totex absolutely in line with the FD would see adjustments to its RCV simply because of averaging when there had been no change in substance.

A3.1.4 RCV adjusting ODIs

We have discussed RCV incentives in more detail in other sections of this document. We would expect to reflect the RCV adjusted for ODI performance in line with reported performance through the Shadow RCV in the annual regulatory reporting process.

A3.1.5 Land Sales

The adjustment for land sales will also need to be reported through the shadow RCV. This should be 50% of the net proceeds from disposals of protected land, which is no change from the previous approach. However, we think that the adjustment needs to be brought into line with other adjustments to the RCV, as discussed in section A3.4.

A3.1.6 Indexation of RCV

As a final step each year in the calculation of RCV, the indexation is applied to provide the outturn value of RCV as the opening balance for the following year.

A3.2 Wholesale Revenue Forecasting Incentive RPI

SVT position:

- We are concerned that as the value of $\mathbf{RR_{t-2}}$ in the WRFIM formula is not specified. While the accompanying spreadsheet uses November RPI for the purpose, the rulebook needs to clarify that this is the case. Under the old Revenue Correction Mechanism, differences between November and financial year average RPI could contribute to a company breaching the 2% threshold at which a penalty interest rate will apply.

- We also believe it would be helpful if Ofwat could be more precise about the income sources that are included in the cap – particularly income from developers.

A3.2.1 Indexation of final determination revenue

The consultation on the WRFIM describes how the penalty rate ought to apply and envisages that where a company has over or under-recovered, a penalty interest rate of 3% applies to the excess. It also sets out a formula which effectively indexes the adjustment for two years' RPI:

$$RFIM_t = -\{(RR_{t-2} - AR_{t-2}) \times [1 + (\frac{I + PR}{100})] \times [1 + (\frac{I}{100})]\} \times (1 + RPI_{t-1}) \times (1 + RPI_t)$$

Since the examples in the consultation are worked in a constant price base, they do not describe how inflation ought to be taken into account in the calculation. That is, they do not specify how we get to $\mathbf{RR_{t-2}}$ in the formula above.

The value of $\mathbf{RR_{t-2}}$ in the formula should be specified as:

- Assumed revenue adjusted to **November 2012** (basket year) prices; less
- Actual revenue deflated using actual November RPI (the rate used to increase in allowed revenues from year to year)

This is consistent with method used to derive allowed revenues in the first year of the control (FD letter) and by specifying this we prevent different approaches being applied.

A3.2.2 Capital income included within the wholesale control

The FD letter states that "the revenue in respect of the Wholesale Activities concerned includes capital contributions such as cash receipts from connection and infrastructure charges (including requisitions and self lay)."

Capital income comes from a number of sources specified in the Water Act 1991 and the Licence. Our view is that the Ofwat definition covers the following types of charge:

	Included
Water: Service Connections (s45)	Yes
Water and Sewerage: Infrastructure charges (as per Licence Condition C)	Yes
Sewerage: Lateral drains (s106) – self lay Sewerage: Lateral drains (s106) – STW lay	Not clear

We think that it may be Ofwat's intention to include charges for lateral drains under s106 within the control as they are the wastewater equivalent to service connections; however, we would not usually refer to these as connection charges. Our interpretation is that all other sources of capital income are excluded from the revenue cap.

A3.2.3 Miscellaneous income

We note that in the most recent version of the proforma tables for regulatory reporting, table 2I (revenue analysis) includes the following items:

- For wholesale: "Third party revenue (price control)"

- "Retail other third party revenue"

This implies that there is an element of third party revenue that is included within the control, which we do not think is the case. At PR14 the following approach was adopted:

- Miscellaneous wholesale income from a number of sources (revenue grants, bulk supplies and third party services and so on) was deducted from the amount that we are able to raise from charges for water and sewerage services.

- Retail income from developer services was assumed to finance the cost of provision and therefore these costs were excluded from the allowed cost to serve.

We think that any variation above or below the FD forecast for these items should not have any impact on the wholesale cap or any effect on the allowed cost to serve within the retail controls.

A3.3 NHH Revenue

Our understanding is that there is no correction for non-household retail and that Ofwat are not considering one. It would be helpful to know what will happen if we over-collect on non-household retail.

SVT position:

- Over collected retail revenue could be seen to be a breach of licence even when due to factors outside of the company's control.

- Ofwat should be clear on materiality thresholds at which point it would investigate further.

- Companies should be able to pro-actively propose remedies to avoid investigation or enforcement action.

We are clear that it is possible to over-collect because non-household retail charges are not all fixed. In addition, the margin is based largely on a percentage of wholesale income. If wholesale volumes are higher than expected, then our charges will recover too much income.

In the example below, retail charges are set in order to recover the expected allowance of £30,769, but volumes are higher than expected. The volumetric charges are designed to recover £25,769, but recover more because the volumes are 1% higher.

Retail variance		Forecast	Recalculation	Actual
Customers	Nr	100		100
Cost per customer in band	£	£50.00		£50.00
Wholesale in band	£	£1,000,000		£1,001,000
Margin	%	2.5%		2.5%
Total retail allowed	£	£30,769	(£50x100+£1.001m) /(1-2.5%)-£1.001m	£30,795
Average per customer	£	£308		£308
Volume	m^3	1,000,000		1,010,000
Fixed retail charge	£	£50		
Variable retail charge	$£m^3$	£0.03		
Total retail recovered	£	£30,769	£50x100+1,010,000x £0.03	£31,027
Over-recovery	£	£0		£232

Given that the Final Determination did not say anything explicit, we asked what would happen if we over-collect retail revenues. We were told:

“Depending on the size, nature and reasons for the non-compliance, we may consider undertaking enforcement action where appropriate. This is for companies to manage as per their Licence conditions and other legal duties.”

This might be interpreted as no correction and no explicit tolerance; we do not think this would be a reasonable approach for the reasons we have set out above. Our forecasts are put together using best available information but will never be perfect and the forecasting error will fluctuate year by year. Enforcement action would appear to be very heavy-handed in these circumstances.

We believe Ofwat should set out guideline thresholds for when it will consider investigations and enforcement action under a risk based approach to ensure its resources are deployed effectively. This should cover the thresholds and cumulative effect over the AMP. For example being under on revenue by 5% in year 1 followed by 5% over in year 2 could exceed a year 2 threshold, even though customers have paid the exact amount over a 2 year period. In this case, there is no overall risk being passed to customers and no need to investigate.

Companies should also be able to propose and agree remedies with its CCG to avoid an expensive investigation process.

A3.4 Land Sales

SVT position:

- At PR14, the treatment of land sales was inconsistent with all other legacy incentives and adjustments to the RCV. We think that consistent principles should be applied:
  - Calculate a real adjustment to the RCV using actual RPI to deflate back to 12/13 prices
  - Apply the real WACC from the period when any financing benefit is earned by the company (i.e. the WACC for AMP6).
- Year by year, the shadow RCV should reflect the actual net value of disposals at outturn prices, with financing benefits being claimed at PR19.

The consultation deals very briefly with land sales, stating that Ofwat will continue with the approach taken since PR94 – that is, deducting 50% of proceeds from the RCV. We don't think this is sufficiently well-defined – within this single sentence there is scope for any type of indexation and any discount rate to be applied (as was the case at PR14).

At PR14, Ofwat deflated actual capex, opex and revenue to 2007/08 prices in order to make a comparison against the assumptions in the 2009 Determination. When taking account of present value, it then used a real discount rate based on the 2009 WACC. While the approaches were slightly different in each case, they were broadly similar in principle.

For land sales, the approach was wholly different. Ofwat took actual land sales at nominal prices and applied a nominal discount rate based on the PR14 WACC to derive the adjustment. This implicitly applied a forecast value for AMP6 RPI to AMP5 values. We don't think this approach is appropriate.

- For historical values, we think the historical rate of inflation should be applied.
- The discount rate should reflect the benefit that was earned on the RCV in the period (for AMP5 disposals this would be the vanilla WACC from PR09 and for AMP6 from PR14).

The approach we have outlined makes accounting for land sales within the shadow RCV simpler, as 50% of the net present value of disposals can be deducted each year. We are not sure how the PR14 method could be applied, since the prospective WACC for PR19 will not be known when annual reports are compiled.

A3.5 Service Incentive Mechanism (SIM)

SVT position:

The consultation sets out that Ofwat will retain the current magnitude of rewards and penalties for the SIM (-1.0% and +0.5%). It does not state how it will do this and the supporting document (SIM for 2015 onwards) provides no further detail.

To be equivalent to the value at PR14, the SIM reward or penalty would need to:

- Be set as a percentage of forecast appointed business turnover in 2019/20
- Add an allowance for tax
- Be indexed to nominal prices using financial year average RPI.

Given that the SIM reward will be applied to household retail, and the significant differences in this form of control, we think that the Rule Book needs to set out how this value will be calculated.

At PR14, the SIM reward or penalty was included within the wholesale revenue requirement at 2012/13 prices. This had the following consequences:

- The allowance was indexed with financial year average RPI, along with all other elements of required revenue
- It was made into a post-tax value – customers paid for the tax on any additional revenue allowed.

At PR14 no indexation was applied to the retail controls, meaning that all amounts involved in retail are at nominal prices. In order to do this Ofwat decided that it would treat real and nominal prices as if they were the same, which we feel is difficult position to support on a pure economics basis and created issues when combining controls. Costs in the retail control were anchored at 2013/14 values.

Our concern is that if the SIM incentive is included within retail controls, and the same approach is adopted:

- SIM rewards will effectively be deflated over the period;

- Companies will bear the tax on the reward (as tax allowances are not part of the retail control)

This second point represented a change from the PR14 approach and the approach at previous reviews where the equivalent incentive – the Overall Performance Adjustment - had been added to turnover outside of the revenue requirement (i.e. companies paid for the tax on the additional revenue).

This would not be consistent with the policy statement that Ofwat will retain the current magnitude of rewards and penalties.

At PR14, Ofwat put significant emphasis on the Return on Regulated Equity that companies could earn through incentives and the potential for out or under-performance. In Ofwat's Risk Assessment Tool, the SIM was assessed as contributing -£11.850m to +£5.869m per year to

RORE for Severn Trent Water. If Ofwat adopts the same approach to SIM as for retail costs at PR14, then it would anchor the value at 2018/19 and it would decline by 6 years' inflation and be worth -£9.924m to +£4.915m by the end of the period.

Such a reduction in the value of the incentive would not be in line with the Final Determination or in the interest of customers, as it would reduce the potential scale of price reductions that they might otherwise receive on account of poor company performance.

To avoid this type of issue in the retail control we would recommend differentiating between the real and nominal values. This would not mean that the control needs to be index-linked, only that inflation is resolved in a consistent manner.

A3.6 IDoKs

It would useful for the rulebook to clarify the procedures for IDoKs in the AMP6 regulatory framework. We recognise that with the move to ODIs certain mechanism such as logging / short falling has been retired but it would be useful to understand the interactions of other relevant mechanisms.

Given the existing licence conditions, the relevant materiality test for a potential IDoK on water rates is a 15 year NPV of the additional opex costs. We believe that as this is set in the licence the move to a totex approach does not affect this materiality calculation.

However, we do seek clarification of guidance around the IDoK calculations, and believe that certain items should not be available for consideration within the IDoK process, namely ODI rewards and/or penalties.

If ODIs were included in any claim or counterclaim, this could result in a high performing company earning rewards claiming under an IDoK (and potentially gaining those ODI rewards sooner) whereas a failing company would struggle to meet the threshold as the penalties offset the cost increases.

Our view of the appropriate process, including other areas that we believe would benefit from clarification is as follows;

- Qualifying items for an IDoK remain notified items or other relevant change of circumstance.
- All claims will be subject to normal triviality and materially tests. For this purpose, they will be valued at 100% of qualifying costs, regardless of the customer sharing mechanism which will subsequently be applied.
- Any successful claim should be applied in line with the agreed FD sharing rate in period. In the case of our only notified item, cumulo rates, the sharing rate is 75:25, therefore 75% of any qualifying costs would be born by customers.

- Historically, output delivery has been used as a counter claim to IDoK claims; we accept that legacy adjustments for the 2014/15 blind year may be taken into account but post 2015 logging no longer exists and is therefore not relevant to IDoKs.

- As noted above, we believe that ODIs should not be eligible in claims or counter claims. The incentive terms are defined in the FD, and in our case ODIs will be taken in period. Setting ODI penalties against IDoK claims would in effect penalise companies twice by preventing them from claiming the cost of relevant changes (or in the case of ODI outperformance, make it easier for them to do so).

One further area where we would like clarification is in relation to the implications of the mini review for non household retail. Our view is this only relates to non household retail and the mini review would not constitute a determination for the wholesale control. If this were not the case and this was considered a determination this could result in the exclusion of pre 2016/17 costs from IDoKs submitted in 2017, 2018 or 2019. We understand that Anglian Water have proposed a license change to clarify this issue.

For regulatory consistency, we request Ofwat clarify the IDOK procedure under the AMP6 framework.

Section A4 Technical responses

Within this section we cover our detailed response to the issues set out in the consultation. We follow the structure of the consultation document and discuss each issue as set out below:

Section A4.1 ODI reconciliation
Section A4.2 Totex menu reconciliation
Section A4.3 WRFIM
Section A4.4 Water trading mechanisms
Section A4.5 PR09 reconciliation mechanisms
Section A4.6 Retail reconciliation

To aid the reader, given the complex and technical nature of the issues, we have set out in each of the sub-sections below a summary of Ofwat's position and Severn Trent's position.

We then follow this with the detail of why we agree or disagree with Ofwat's preferred options, including worked examples to illustrate our points, where appropriate.

The main concerns raised in this section are:

- The simple approach to financeability Ofwat has adopted which ignores key implications of some of the proposed mechanisms.
- Incomplete calculations (for example no consideration of the 'blind year' in relation to ODI incentives).
- Implications of inconsistent approaches, particularly when items will feed into the same financial model at PR19.
- Due to the areas of omission outlined in section 1.3 above, the impact of some items within the mechanisms (particularly in relation to the shadow RCV) have not been fully considered.

SEVERN TRENT WATER

Section A4.1 ODI reconciliation

Ofwat position:

- Use actual average year RPI to inflate PR14 values to PR19
- Do not adjust for the time value of money
- Allow taxation on ODI rewards and penalties as part of PR19 review
- Do not adjust ODI rewards and penalties for taxation comparison with cap and collar
- Principles set out for assessment of major scheme ODIs at PR19
- Requirement for companies to publish further details for asset health measures
- Suggestion that all companies publish calculation method for all ODIs where not set out in FD.

SVT position:

- We agree that incentives rates should be indexed with RPI and also that a Nov-Nov rate is appropriate.
- We **do not** agree that the time value of money should not be taken into account. We do not consider that it would overly complex and believe that the risk of perverse incentives outweighs the apparent complexity and therefore is in the best interests of customers and companies to take this into account.
- We agree that the tax treatment of ODIs has drawbacks either way. We agree that the treatment should be consistent regardless of when (in period or PR19) and how (Revenue or RCV) the ODI is applied, and should be in line with the treatment in financial modelling at PR19.
- We agree that there are some uncertainties around the ODIs where the information in the FD is unclear, and that information was shared with Ofwat that was not published in full in the FD documents. We agree that some further clarity is required, and that CCGs would be a good forum to test proposals. We also set out our draft proposals for the in-period ODI mechanism, which again is not included in the consultation.
- We also think that there is a need for Ofwat to set out how common pan-industry ODIs will be measured, as Ofwat has for SIM, such that all companies are clear on exactly what must be reported and how it must be calculated to ensure fairness and transparency for these measures.
- We also think there is a need to clearly set out how any ODIs will be trued up where they are based on forecast data, 'blind year' information in relation to ODIs appears to be missing from the consultation.

ODI reconciliation overview

Severn Trent has in-period adjustments to revenue, so it is important that we can confirm performance and calculate ODIs in good time to factor them into charges.

This section of our response covers each of our ODI position points and outlines our review of the ODI Reconciliation Model, as set out below:

1.4.1.1 – Indexation
1.4.1.2 – Time value of money
1.4.1.3 – Taxation
1.4.1.4 – Measurement clarifications
1.4.1.5 – Industry wide ODIs
1.4.1.6 – Blind year ODI treatment

As previously stated in section A2 above, we believe that the treatment of performance incentives at PR19 could be separated from outturn 'true-ups'. ODIs are clearly a performance incentive, and the impact of AMP6 ODIs therefore could be applied after any financeability assessments at PR19 and in addition to any revenue requirements calculated for AMP7. However, although logical when considered in isolation, this could cause perverse incentives in relation to totex outperformance; more detail on our position is included in the opening section of this response and in section A4.2.5.

A4.1.1 – Indexation

As all ODIs were stated at 12/13 prices in company submissions and the FD, we agree that indexation should apply to the incentive rates.

As the full year average RPI will not be known at the time of setting prices for the following year for in period adjustments, the November to November annual average is the most appropriate indexation metric for adjusting ODI incentive rates for inflation.

Ofwat have proposed that ODIs adjusted at PR19 be inflated with the actual year average. Although inconsistent with the in-period adjustments, we consider that the impact is likely to be minimal, and that it is more important that the PR19 adjustments are consistent with the inflation index used in the PR19 modelling (which, we assume will be the actual year average)

Therefore we fully agree with Ofwat's proposed approach to indexation of ODI incentive payments.

However, we note that in the ODI reconciliation model, Ofwat have included a calculation sheet for the cap & collar values. We assume that this is so that companies can confirm values used and will be removed from the final model. We agree that the values included for Severn Trent have been deflated to 12/13 prices using the RPI override rates from the FD financial model, and suggest that to avoid confusion these are included as a fixed input and the inputs calculation section is removed from the model.

A4.1.2 – Time value of money

We consider that the timing of ODIs payments should not impact the value created for or repaid to customers.

We believe that both types of incentives (those taken during AMP6 and those received in AMP7) should have the same value to companies. That is, the time value of money should be applied to ODIs.

We think that it is important that the treatment should be fair and consistent between companies. Furthermore, applying the time value of money to incentives will retain the value of incentives and therefore ensure customer protection where companies are in penalty.

We do not believe that a Net Present Value (NPV) calculation would be particularly complex or controversial, as suggested by Ofwat in the consultation. Companies will be asked to assess rewards and penalties on an annual basis when the information is available to do so. For incentives that are assessed over a number of years, there is a defined time at which the value is calculated.

Perverse incentives

Ignoring the time value of money will cause an erosion of the value of penalties (and rewards). As ODIs are weighted towards penalties, the most likely outcome in this scenario is that customers end up over-paying. For that reason, we believe that Ofwat's preferred option is not in the best interests of customers, as is noted in the consultation.

As we have in-period adjustments, we would gain a benefit (or penalty) compared to other companies, because our rewards/penalties (coming sooner) would be worth more in real terms. But our reward and penalty range would be worth less than envisaged in the FD, where this was calculated in flat 12/13 prices. For example, ODIs calibrated at 2% of regulatory equity would shrink to around 1.9% for ODIs received in period and 1.7% for ODIs not received until PR19.

As many ODIs will include blind year data, there is also the risk that companies will include optimistic forecasts for this blind year in order to reduce any potential penalty, knowing that due to the time value of money, any later adjustment for incorrect forecasts will effectively be at a lower value.

Furthermore, in future, companies (particularly those who have not yet elected to take in-period ODIs) could structure their AMP7 ODIs in such as way as to include the more risky ODIs as end of AMP adjustments and those which were more likely to provide a reward as in-period adjustments.

By applying the time value of money, the potential to 'game' by delaying penalties by the selection of ODI type, or by providing overly optimistic forecasts of the blind year performance is eliminated.

Complex calculation

Ofwat's position appears to be that because it might be difficult to agree how the NPV calculation should be applied, that it should not be attempted, and that this carries more weight that the issues highlighted above. We do not consider this argument to be persuasive as we do not think that NPV calculations would be complex or difficult to implement, it simply requires clear rules to be set out now.

Ofwat also cite the fact that some ODIs will be based on forecast data as a complexity. This applies to the majority of ODIs, for which forecasts will be required to calculate the ODI incentive for PR19 anyway. It is not clear why this adds any additional complexity in relation to NPV calculations. The same assumptions and rules should apply as for any other ‘blind year’ adjustments and true-ups. Furthermore, without the NPV calculation, these forecasts could be used to manipulate the timing of penalties.

Proposed methodology for NPV calculation

ODIs are set out in each FD. Each ODI either has an annual target, or a single target (usually in year 4 or 5 of the AMP), the NPV calculation should start at that defined point. I.e. the point an ODI is measured is the point at which the penalty or reward is measured against the target set in the FD.

If a company has an ODI that is difficult to measure, this is a separate consideration in relation to the calculation of the ODI itself and not a factor in the NPV adjustment.

Where there is ambiguity, for example our catchment management ODI is measured in year 4 and the FD is silent on how we treat year 5 data. We believe that the treatment should be set out by the company early in AMP6, for example at the 2015/16 year end to clarify any such ambiguity. (For further detail see section A4.1.4, measurement clarifications).

The incentives are then paid/received either in-period, at the end of AMP6 or spread over AMP7. The timing of the payments would need to be agreed at the point that the NPV calculation is made (where this is not yet determined in the FD), but the model to calculate these different options could be set out in advance and would not be particularly complex in nature.

As the NPV calculation eliminates any value erosion, the differences in the timing of the payment would not influence when the payment is taken and therefore will not cloud decisions either for in-period or PR19 adjustments.

The final point raised in the consultation relates to incentives added to the RCV versus those received through revenue. We believe that the NPV calculation should be made up to the point the adjustment is made, i.e. the year that the revenue element is collected from customers, and the year in which the RCV is adjusted (usually a midnight adjustment at the end of 2019/20). This would be in line with other proposals in the consultation where NPV is being applied, and we do not consider this proposal to be controversial or complex.

Example calculations

To illustrate our point we include a series of examples below:

Please note that the performance included in all of the examples below is for illustration only and should not be used to infer our anticipated or forecast performance. In addition, to simplify the example we have not applied RPI to the calculation. In reality this would be applied and therefore the incentive rate would increase each year.

The first example below shows how an in-period adjustment to revenue would be adjusted for the time value of money. In this example, the target is annual, and the payment is annual, with a 2 year delay. It is assumed payment is made in full each year (rather than spread).

We have used our leakage ODI to illustrate this point.

Revenue in period	2015/16	2016/17	2017/18	2018/19	2019/20	Total
W-B2: Leakage (annual target)						
Target (Ml/d)	444	439	434	429	424	
Performance (actual)	440	434	430	426		
Performance (blind year)					423	
Reward/(Penalty) multiplier	4	5	4	3	1	
Reward (£)	492,000	615,000	492,000	369,000	123,000	2,091,000
Date payment made	2017/18	2018/19	2019/20	2020/21	2021/20	
Number of years delay before payment	2.5	2.5	2.5	2.5	2.5	
NPV using WACC (3.6% pa)	537,4832	671,853	537,483	403,112	134,371	2,284,301

If the WACC were to change at PR19, any NPV adjustment from 2020/21 would need to use the revised WACC, with the above rate used for NPV relating to periods up to 2019/20.

The second example relates to a PR19 ODI but where each year's reward is adjusted up to the final year of the AMP. At PR19, the adjustment would be unwound to calculate the NPV effect using the AMP7 WACC. The adjustment could then be spread evenly across AMP7 revenues. We have not shown this aspect of the calculation in our example below as the approach will be similar to the calculation Ofwat performed at PR14 for CIS and that Ofwat has proposed for the true up of totex incentives.

The reward or penalty is applied in 2019-20, with five years' reward/penalty based on number of improvements delivered to 2018-19 plus those expected performance to be delivered in 2019-20.

We have used our Waste, River water quality ODI to illustrate:

Revenue in AMP7	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/20	Total
S-C1: Improvements in river water quality against WFD criteria						
Target					202	
Performance (actual)	n/a	n/a	n/a	n/a		
Performance (blind year)					210	
Reward/(Penalty) multiplier					8	
Reward/penalty £150,000 pa for each improvement by 2020.	n/a	n/a	n/a	n/a	6,000,0 00	6,000,000
Number of years of NPV	4.5	3.5	2.5	1.5	0.5	
NPV using WACC of 3.6% pa from 2019/20 (1-5 years)					6,107,0 45	6,107,045

In our final example, the ODI is measured annually and adjusted via a midnight adjustment to the RCV at the end of the AMP. In this case, each year's penalty is adjusted up to the final year of the AMP. We have used our water quality measure, number of sites with coliform failures to illustrate.

RCV midnight adjustment	2015/16	2016/17	2017/18	2018/19	2019/20	Total
WA-3: Sites with coliform failures (annual target)						
Target	<8	<8	<8	<6	<6	
Performance (actual)	8	8	8	7		
Performance (blind year)					6	
Reward/(Penalty) multiplier	(1)	(1)	(1)	(2)	(1)	
Penalty (pre-NPV) £463,000	(463,000)	(463,000)	(463,000)	(926,000)	(463,000)	(2,778,000)
Date payment made	2019/20	2019/20	2019/20	2019/20	2019/20	
Number of years delay before payment	4.5	3.5	2.5	1.5	0.5	
NPV using WACC of 3.6% pa up to 2019/20	(542,875)	(524,011)	(505,802)	(976,451)	(471,260)	(3,020,399)

In all of the above examples, we have assumed that the NPV calculation is for mid year, applied at the year end. Particularly for revenue payments it is appropriate to assume the payment is made at the mid point of the year, given that revenues will be received throughout the year.

Given the above, we disagree with Ofwat's position that calculation of NPV in relation to ODIs is too complex to perform, and suggest option 1 should be adopted as we have illustrated above.

To further assist Ofwat, we have amended the ODI model to include NPV calculations. We have included this in the 'Calcs – ODI 2' tab to illustrate the mechanism (rows 88 to 196) with some additional inputs required in 'Inputs_ODIs' tab (rows 19 to 24).

A4.1.3 – Taxation

Taxation on individual ODIs

Ofwat changed its approach to incentive revenue at PR14. Incentives were set as post tax additions to revenue; they had been pre-tax values at PR09. However, the picture was mixed – companies were not given the value of tax on "true-ups", and some "incentives" also had tax deductions applied. The question is whether ODIs should be treated as pre-tax additions to revenue (like PR09) or post-tax values (PR14).

As noted in the consultation, willingness to pay research established the value that customers placed on a unit of improvement at a value; they were not asked to provide a post-tax value. However, we agree that not all ODIs were based on the willingness to pay, and other factors and judgements also played a part in the incentive calculations, so on balance we do not consider that willingness to pay should dictate tax treatment.

However, we do not think the ODIs that we receive should be a lower strength than other companies simply because we are taking them early. At PR14 Ofwat included incentives within allowed revenue in its financial model. Extra revenue leads to extra tax – so an

additional £4 of incentive translates to £5 of allowed income. Therefore we agree that all incentives (in period and PR19 adjusted) should have the same tax treatment.

We think that using the marginal rate of tax is the correct approach. For an extra £1 of revenue, assuming a 20% headline rate, the company should pay 20p more tax. The effective rate of tax is influenced by a number of things – capital investment, interest; losses brought forward, rebates relating to previous years – none of which have anything to do with receiving more income.

We do understand that funding (or deducting) tax on this income could be problematic when there are some companies which pay no current tax. A simple approach would be for Ofwat to apply an in-period "gross-up" only where the company expects to pay current tax on the revenue; the company could be required to return this component of the allowance at PR19 if it paid no tax in the relevant year.

Taxation on the cap and collar calculation

Ofwat propose that the tax treatment for the cap and collar limit is not adjusted for tax. We note that this is a departure from the proposal in the FD, but agree that as the tax treatment of the ODIs was not defined in the FD, the adjustment now is valid to ensure consistency with the tax treatment of the ODI values themselves.

However, the tax treatment under this Option will mean that the cap/collar is less than the published P10/P90 values. The reason for this is that the P10/P90 figures were calculated under a different assumption for tax. We do not consider that this is a material issue as these figures were only illustrative.

A4.1.4 – Measurement clarifications

There are various issues which we discuss in this section.

- How in-period ODIs will be measured and the mechanism for payment
- Measurement of certain ODIs where the FD is silent or the methodology is unclear.
- The proposals set out for the measurement of scheme ODIs
- The proposals set out for asset health basket measure ODIs

In-period ODIs

Firstly, given that Ofwat will require assured performance data before allowing payment of incentives we have assumed the following:

- ODI performance for 2015/16 will be reported in June of the following year (i.e. June 2016), with the assurance taking place between March and June.
- As the charging scheme for 2016/17 will have been agreed in December 2015, in-period incentives will not be applied, as the value will be unknown at this time. (We do not believe that we will be able to obtain external assurance of forecast data, and therefore will not meet Ofwat's criteria per the licence).
- Therefore the first available charging year to adjust for 2015/16 performance will be 2017/18 (year 3).

We believe that the above assumptions are in line with Ofwat's position in the consultation on the new license conditions in relation to in-period revenue adjustments.

Proposed mechanism

Given the above, for in-period ODIs we will have incentives for year 4 and year 5 which will not have been taken at the time of the PR19 determination. Therefore we seek confirmation that the treatment of these ODI payments will not be affected by any PR19 mechanisms.

In addition, we would like to be able to choose how and when we apply any adjustment. For example, we may:

- Apply full reward/penalty in the next available charging year
- Hold over a bill increase due to outperformance if we think we may be in penalty in a subsequent year, and net off any adjustment (or vice versa).
- Choose to spread the reward or penalty from one year over more than one year's bills (for example if we have a large value penalty or reward in a single year).

Finally, we seek assurance that the cap/collar mechanism will also be applied to in-period adjustments. For example, we may have a very bad first year on a particular Performance Commitment (PC), followed by significant improvements in performance over the remainder of the AMP. It could be the case that the ODI penalty creates a significant fall in bills in year 3, but then a large increase thereafter. We know from research that our customers would prefer stable bills rather than annual increases and decreases.

We therefore suggest that for in period adjustments, one fifth of the full AMP cap/collar value is applied as a constraint on the value included in each year. Any value in excess of the annual limit would be carried forward and applied in a different year, provided:

- It did not cause the limit for that year to be breached; and
- It did not cause the 5 year total constraints to be breached.

In essence, we are suggesting that the annual cap/collar should only alter the timing of in-period adjustments. The overall constraint on the value returned to customers (or recovered from customers) at the end of the AMP should remain the same.

To illustrate:
If the Severn Trent cap is £134.91m, the annual cap would be £26.98m. In the example below, the year 1 penalty value is £30m which would be above the cap. We believe that the gap (£3.02m) should be carried forward to apply in another year. This would protect companies and customers against large annual adjustments to bills.

Water	Year 1	Year 2	Year 3	Year 4	Year 5	Overall
No annual cap/collar						
Reward	2	5	10	10	15	42
Penalty	30	15	10	5	2	62
To apply to bills	(28)	(10)	-	5	13	(20)

Water	Year 1	Year 2	Year 3	Year 4	Year 5	Overall
With annual cap/collar						
Reward	2	5	10	10	15	42
Penalty	30	15	10	5	2	62
Reward on bills	2	5	10	10	15	42
Penalty on bills	(27)	(15)	(10)	(5)	(2)	(59)
Total on bills	**(25)**	**(10)**	**0**	**5**	**13**	**(17)**
To carry forward	(3)	-	-	-	-	(3)
						(20)
Actual applied to bills	(25)	(10)	(3)	5	13	(20)

Therefore, we recommend that the following guidelines are set out for in-period reward/penalty mechanisms.

- The company will provide Ofwat, along with the value of any in-period ODIs earned, the proposed timing of the revenue adjustments. If no timing is proposed it is assumed that the ODI adjustment will occur in full in the next charging year, up to the annual cap/collar value.
- Ofwat will take such requests into account and not unreasonably withhold its approval of such requests, particularly where the company can demonstrate it has actively engaged with its CCG and has consulted on how and when the ODI adjustments will be applied, and the company has taken reasonable account of any concerns raised.
- Inflation and the time value of money are taken into account such that if a company chooses to delay all or part of an incentive, it does not forgo part of the penalty or reward.
- All mechanisms are symmetrical and apply equally to penalties and rewards. For example if there was a penalty on one ODI and a reward on another, the same mechanism is applied to both for that particular year.
- The amount of any reward or penalty applied to bills in any single year should not exceed the value of one fifth of the cap/collar for each price control. This does not mean that the penalty or reward is foregone, but simply that the timing of any payment is adjusted to prevent a breach of the cap/collar.
- Should the company and Ofwat disagree, the default position is that the full value of any reward earned or penalty applied is taken in full in the next available charging year (up to the annual cap/collar value).

Measurement clarifications (general)

The second area we discuss is the measurement of certain ODIs where the FD is silent or the methodology is unclear. Ofwat propose that it would be 'best practice' for all companies to publish details of how all of the ODIs are measured, but do not require companies to do so.

We believe that all companies should ensure that they have a clear methodology for measurement of ODIs. We have some ambiguity in our published data, for example;

Performance Commitment W-A4: Successful catchment management schemes.

This has a target of 12 schemes with a cap at 21 schemes. The PC is measured once, in year 4.

However, the FD is silent on how year 5 performance is measured. Therefore we may have implemented 18 schemes and be close to implementing 2 more at the end of year 4. We could include the forecast performance for year 5, or exclude the forecast performance. If we exclude the performance in year 5, it might be reasonable to roll this forward to include in an AMP7 target.

We consider that a methodology should be proposed and discussed with the CCGs, and Ofwat, before the point at which the ODI is to be measured and reported (in this case, year 4 of AMP6). This should prevent any late disagreements on how an ODI should be measured and the level of incentive earned or owing. Clearly, the sooner these are agreed and reported to Ofwat/CCG the better.

Measurement clarifications – scheme ODIs

Ofwat has set out 5 options in the consultation in relation to scheme ODIs. For Severn Trent the Birmingham Resilience scheme, for which we have six ODIs, falls into this category.

Ofwat's proposed option sets out some principals for companies to follow but does not require any action now, and proposes it will only assess performance as it is reported (either in-period or at PR19).

The principles set out in the consultation are (in summary) as follows:

- The FD takes precedence over any additional documentation where there are inconsistencies
- Companies will be subject to a high burden of proof at PR19 (but no mention of in-period measurement is made)
- If an alternative has been implemented an even higher burden of proof is needed and a company must demonstrate that additional benefits were delivered to customers, or a statutory requirement was removed.
- Delayed incentives will be assessed at the end of the year the scheme was due to be completed, and at PR19 if sooner.

We have some concerns in relation to the above points.

Firstly, the FD is very high level, and therefore we are not sure that it is appropriate that is should 'take precedence' over other documentation, particularly in relation to the measurement of the ODIs. For example, for the Birmingham Resilience Scheme, we provided detailed appendices to our plan submissions for these ODIs, which hold far more detail and explanation of the ODI measurement than summarised in the FD.

Furthermore we have documented the measurement of the milestones, which show how these are split into the agreed segments, something which is not included in the FD.

Secondly, whilst we agree that companies should be able to demonstrate that a scheme is operational and delivering the intended benefits to customers, it is not clear who that proof needs to be provided to. If we have independent assurance that a scheme is delivering and this has been shared with the CCG who have not raised concerns (or such concerns have been addressed), does all of the proof, including the assurance report, also need to be provided to Ofwat, and as such, could the situation arise where Ofwat deems the proof to be insufficient (for example because it does not have the full assurance report) and applies a penalty?

The consultation appears to suggest it is Ofwat that will assess these schemes rather than an independent assurer or the CCG, and therefore we would like Ofwat to clarify its role and whether it would need to be party to the assurance agreements. Also we think that Ofwat should clarify what role it believes the CCG would have in this process, other than as a body to which companies report progress. It appears from the consultation that this is the only role the CCG would have in this scenario, given it does not include the option to work with CCGs to set out the measurement of delivery (only included in options 3 and 4).

It is unclear why Option 3 is considered inconsistent with FD and difficult to implement, we would consider this to be a better option, as the requirement to be consistent with the FD would still apply.

Finally, Ofwat set out proposals for asset health basket measure ODIs. Although Severn Trent does have some ODIs which include a basket of measures (for example biodiversity) these are not related to asset health. Therefore we assume that the proposals here would not necessarily apply (although we would expect similar treatment would be best practice).

Our view of these measures is that we are unclear why the consultation takes such a different approach to basket ODIs than to scheme or any other ODIs. If Ofwat feel that companies should be required to publish data on these measures where there is uncertainty, it is unclear why this is not a requirement for other (particularly scheme) ODIs.

We would consider it best practice to publish this data for all ODIs and believe that before any performance is reported, and ideally in the first annual report of AMP6, this information should be made available, ideally following consultation with the CCG.

A4.1.5 – Industry wide ODIs

In the FD, Ofwat set out five performance commitments (PCs) where it had imposed industry wide upper quartile targets. These PCs were:

- duration of supply interruptions;
- number of contacts from customers regarding water quality;
- compliance with DWI water quality standards;
- number of sewerage pollution incidents; and
- number of properties impacted by internal sewer flooding.

In addition, Ofwat has set out its proposed SIM mechanism in the consultation. In a similar way to the SIM, we believe Ofwat should set out clear measurement criteria for all pan-industry measures to ensure these are consistent and fair. This could be achieved by

requiring companies to publish their intended measurement methodology prior to initial measurement, and any inconsistencies being adjusted for and agreed with Ofwat before March 2016.

A4.1.6 – Blind year ODI treatment

We will have both end of AMP (example below) and in-period penalties or rewards which will not be known at the time of the PR19 determinations, specifically the outturn of years 4&5 at Draft Determination and the outturn of year 5 at Final Determination.

Therefore, if actual outturn results in a change to an ODI, a true up will be needed.

We believe that for revenue adjustments the true up should be taken in AMP7 (in-period adjustment at year 2) rather than delayed to PR24. All company licences could be updated at PR19 to allow this, even if companies do not elect to take additional in-period ODIs at AMP7. We believe that RCV adjustments should be adjusted to present value (by applying depreciation and WACC returns) and applied at PR24 as an opening balance adjustment.

Illustration:
W-A3: Asset stewardship – number of sites with coliform failures

We have committed to <8 sites with failures in the first 3 years and <6 sites in 18/19 and in 19/20. There is a penalty applied for each site above the target for each year of the AMP, as an opening adjustment to RCV for AMP7.

Our performance may be as follows:

	2015/16	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**Penalty**
Target	<8	<8	<8	<6	<6	-
Reported	9	8	7	6	5 (forecast)	£463k x 3
Actual	9	8	7	6	**6**	£463k x 4

In this example the adjustment to RCV included at PR19 would be incorrect, as the value was based on a forecast for 2019/20 which was different to outturn.

RCV adjustments will impact financeability calculations included in the FD, and therefore an adjustment at PR24 seems the most appropriate method.

The NPV and RPI adjustments would also be required for any delay in the application of the incentive for both rewards and penalties.

Section A4.2 Totex menu reconciliation

Ofwat position:

- Exclude items not included in the menu baseline
- Compare totex at 2012/13 prices and therefore deflate actual spend with actual RPI.
- Use a weighted average PAYG rate to allocate under or out performance to revenue and RCV.
- Total totex adjustment adjusted for the time value of money to share under or out performance with customers
- Only include a taxation adjustment for RCV changes
- Ignore the financeability effects of sharing outperformance with customers at PR19

SVT position:

- Agree with the method of indexation and exclusion of items outside the baseline.
- Agree that totex adjustments should be split between revenue and RCV.
- The annual PAYG rate should be used, as the use of an average will distort reconciliations of expenditure and the presentation of the shadow RCV.
- The same tax treatment should be applied to both the RCV and revenue elements of the adjustment; the incentives should all be treated as post-tax amounts consistent with honesty (“ex-ante”) rewards and penalties at PR14.

We agree there is a difference between the economic benefit of outperformance (the circa 50% of outperformance that a company earns) and the revenue adjustment that should be made to return benefits to customers. The revenue element of the incentive at PR19 should be a share of the revenue that was allowed for expenditure savings (or over-runs) and the balance should be adjusted through the RCV. The rulebook proposal reflects this principle.

However given that the PR19 revenue adjustment for out-performance will be negative, we think that it should be applied before financeability otherwise it will give rise to a perverse incentive. We think Ofwat should consider whether it is reasonable to continue with a two-stage approach to financeability given the way that other areas of the framework have changed. It would be perverse for an efficient company to find itself unfinanceable in AMP7 because of its outperformance. We have outlined some alternative approaches in section A4.2.5.

Totex incentive calculation methodology

Having reviewed the totex menu:

- We agree it would not be reasonable to return the whole of this value to customers at PR19 as a revenue adjustment; as this would treat the amount as if it had all been PAYG basis. The company would give back more revenue than had been allowed, for that amount of totex.

- It is right that the full value should be measured in a company’s Return on Regulatory Equity (RORE). This is a measure that shows the economic value of cost savings achieved.

We agree with the approach set out in Ofwat's illustrative spreadsheet where the true up of the totex menu incentive includes:

- an ex-post reward/penalty that calculates the difference in revenue to be shared with customers based on the costs the company actually incurred; and
- an adjustment to the RCV to reflect actual spend.

There are however, certain aspects of the totex adjustment calculation where we do not agree with the approach proposed in the illustrative model. These are set out below;

A4.2.1 Treatment of ex ante income in AMP7

At PR14, the ex ante income was all received through allowed revenue. Arguably, part of the ex ante income "ought" to have gone to the RCV, since the difference in expenditure related to money that would be treated as capital as well as PAYG. We accept that an ex-ante adjustment to revenue alone is reasonable for simplicity, but when it comes to the true-up, this should be recognised - the ex-ante reward should be netted off the revenue element of the adjustment. This is consistent with our earlier point that incentives should match the in period revenues.

In the illustration below, the company has spent less than Ofwat's baseline of £100m and outperformed its own estimate of £105m. The company will therefore retain 49% of the cost savings it has achieved and return 51% of the savings back to customers. The total reward to be earned by the company at PR19 for the £6.3m cost outperformance will be £3.06m. A total of £1.91m must be returned to customers as £0.64m of this was already given to them up front at PR14. The adjustment for the time value of money has been ignored in the illustration.

1. AMP7 - Ex post reward/penalty	Company portion of reward	Customer portion of reward
Menu choice	105	
FD PAYG rate	60%	
Cost performance incentive rate	49%	51%
Allowance	101.3	
Less: Actual totex	95.0	
Variance on totex spend	6.3	6.3
Total reward/(penalty) (£101.25m - £95m) x 49% + -0.64m	2.43	2.55
Deduct honesty incentive (Ex-ante income)	(0.64)	0.64
Net efficiency ("Ex-post") reward	3.06	1.91

The revenue amount returned to customers in AMP7 should be reduced by the "honesty" incentive which they have already received in AMP6 price limits (in this case it was a penalty because the company's plan was higher than Ofwat's assessment).

Table 2 illustrates how the reward/penalty could easily be split between revenue and the RCV on a PAYG basis with the ex ante income then netted off the revenue element.

2. Split reward/penalty between revenue and RCV	Company portion of reward	Customer portion of reward
PAYG element of reward/ (penalty): (£2.43 x 60%)	1.46	1.53
Add back honesty incentive (Ex-ante income)	0.64	(0.64)
Net revenue (ex-post) reward	2.09	0.89
RCV element of reward: (£2.43 x 40%)	0.97	1.02

We note that this is different to the approach set out in Ofwat's illustrative spreadsheet. In section 3.3 of the spreadsheet, the aggregated reward/penalty is split between the RCV and the future revenue adjustment for AMP7. We don't think mixing revenue amounts and capital in this way is correct – customers had the benefit of this revenue reduction in their bills within AMP6; we don't think that part of this revenue should now be capitalised. It should be set off against the revenue shared with customers in AMP7.

A4.2.2 PAYG rates

Whilst we agree with Ofwat's proposed approach of allocating totex out/underperformance to revenue and RCV we do not agree with the proposal to use a weighted average PAYG rate.

We see no benefit in using an average PAYG rate across the AMP. Using an average rate would distort the true-up of expenditure and the presentation of the shadow RCV. We think that as the allowed costs in the RCV and revenue are based on company's annual FD PAYG rates, it would make sense for actual spend reflected in the RCV and the adjustments to futures revenue to be calculated in the same way.

From a review of PWC's assessment of the options for applying the PAYG rate to totex out/underperformance we note that the calculation of the weighted average PAYG used in option 3 (using the weighted average) appears to be inconsistent with the calculation set out in the illustrative spreadsheet. The effect is that under option 3 the adjustment to revenue would be almost half than currently shown in the illustration with a much larger adjustment being applied to the RCV.

A4.2.3 Tax treatment of menu incentives

We have considered whether an adjustment for tax should be included. We think Ofwat needs to be clear about whether the overall reward is intended to be a pre or post-tax value.

- At PR09, the ex-ante element of the CIS reward was treated as a pre-tax value – companies bore the tax on any additional income. At PR14, the ex-post reward was treated as post-tax – customers funded any additional tax.
- At PR14, ex-ante income has been treated as a post-tax value (customers fund tax).

- However, as noted above the Risk Assessment Tool (RAT) treated all incentives as pre-tax values (i.e. companies were **not** funded for incentive revenue earned).

Either way, the treatment of the two elements of the reward (ex-ante and ex-post) should be consistent.

Option 1 – the reward is post tax: The net revenue to be shared with customers would be included in the revenue requirement, with no further adjustment. So, in the case above the company would get a post-tax revenue reduction of £1.09m (the customer share), and this would generate a tax reduction in Ofwat's financial model. The reduction in allowed revenue would become £1.36m if the company pays tax. This would be generally consistent with the way that PR14 legacy incentives were implemented.

Option 2 – the reward is pre-tax: The net revenue to be shared with customers would need to be adjusted for tax before it is included in price limits. Since the ex-ante income was expressed as a post-tax value, it would need to be grossed up to show the revenue effect of that penalty.

3. Revenue element of reward is pre-tax	Company share	Customer share
Gross revenue adjustment before tax	1.56	1.53
Honesty incentive, pre-tax: £0.64 / (1-20%)	0.80	(0.80)
Net revenue ("Ex-post") reward - pre-tax	2.25	0.73
Tax adjustment @20%	(0.16)	(0.16)
Amount to be included within the financial model	2.41	0.89

So, in the case above, the revenue requirement in AMP7 would be reduced by £0.89m to share outperformance with customers. The financial model would then calculate tax, bringing this back to a £0.73m reduction in allowed revenue. This would be broadly consistent with the RAT, but there would be issues with companies that pay no current tax, as we discussed in the section on ODIs.

Option 3 – tax adjustment to the RCV element only – this is Ofwat's preferred option, and not one that we had considered before the consultation was presented. We do not understand the logic behind this distinction, and - given that this tax adjustment is not included in the spreadsheets that Ofwat put out alongside the Rulebook - we do not understand how this would work in practice.

We think the AMP7 adjustment should be a post-tax value (i.e. option 1). This method is consistent with the approach taken for legacy incentives at PR14. It also means that any issues around the effective tax rate paid by companies will fall away. For example, a company which has generated a loss for tax purposes would see no change in allowed tax due on incentives unless these were sufficient to move it into profit.

In addition to consistency with the honesty reward or penalty at PR14, Option 1 is the only approach where revenue and RCV adjustments would be consistent. This is because any adjustment to the RCV is effectively post-tax; companies earn a post-tax

return on capital and the tax on this income is an additional element of the revenue requirement.

As we have discussed above, any amount that is added to the revenue requirement (incentive revenue or the return on the RCV) will generate tax. The only difference is in timing - the RCV adjustment will generate tax based on the return over an extended period, whereas the revenue adjustment only affects a single AMP. This is why we believe that the only appropriate method is our option 1 above.

A4.2.4 Time value of money

As we have set out in previous sections, we think that the time value of money should be recognised in all incentive calculations. We are pleased that this is also Ofwat's preferred approach in relation to totex incentives. As correctly identified, taking no account of present value (option 1) would create perverse incentives to target early savings rather than providing a consistent rate of reward for efficiency.

We find it odd that Ofwat considered an option where it took account of present value of the non-PAYG element of totex alone. The time value of money is a general principle of finance – money spent or received earlier has more value whether it is notionally invested or notionally expensed.

The method used is slightly different to other mechanisms which recognise the time value of money. The totex model recognises cashflows occurring in the middle of the year, whereas other mechanisms (for example, the Wholesale Revenue Forecasting Incentive spreadsheet and formula) have a more simplistic approach. In our view, the approach within Ofwat's totex model is better but we think that it is important that the method should be consistent between incentives.

A4.2.5 Financeability impact

Ofwat position:

- Policy is to look at financeability before the impact of incentives; therefore the effect that incentives have on financial metrics does not need to be considered.
- Efficient companies will be able to use their savings to offset the impact of returning cash to customers in AMP7.

SVT position:

- This policy was developed under an older framework when any negative adjustment to revenues was for a penalty, not for efficiency savings. It would be perverse for efficiency to make a company unfinanceable.
- Continuation of this policy creates perverse incentives. To remain credit worthy in future, a company should avoid excessive outperformance and rather re-invest any efficiency savings.
- This is not in customers' interests. Customers will prefer bill reductions to inefficient levels of investment and it disincentives companies to push the totex frontier.
- The current approach will become increasingly complex to implement if there are more price controls that are set at different times, and Ofwat needs to assess the

financeability of each of them independently.

- We propose some simple alternatives that resolve these perverse incentives.

In order to respond to incentives, we think it is important to know what effect they will have upon the company. This includes the way that they will be treated at PR19.

We understand that this consultation is about finalising PR14 rather than PR19, and that the approach to the next periodic review will evolve as part of the Water 2020 project. But the impact that these incentives will have on us in future has a bearing on the way the company operates in AMP6. We think the treatment of incentives and true-ups within a future financeability assessment are relevant to this discussion.

Ofwat's historical approach has been to consider financeability before the application of incentives. The original reason for this was that Ofwat's solution to financeability issues had been to provide additional revenue (a PV-positive adjustment). Without this approach, Ofwat could thus have been in the position where it applied a legacy adjustment then returned all of the cash because the penalty had made the company un-financeable.

We think this policy needs to be re-examined, particularly in light of the way that totex incentives will work in future:

- The original reason for the two stage approach no longer applies. Ofwat does not provide NPV-positive revenue adjustments to resolve financeability issues. A change in the PAYG ratio is NPV neutral, only affecting the timing of cashflows.

- Many of the legacy revenue adjustments are not incentives. For example, revenue correction from prior periods is a true-up; it is part of the form of the price control.

- Sharing totex outperformance with customers in future will mean that there is a negative adjustment to allowed revenues in AMP7. Traditionally negative adjustments only arose when the company had delivered poor performance; it would be perverse if this approach led to an efficient company being made unfinanceable.

It might be argued that an efficient company will have saved money during AMP6 and will therefore be in a better position to deal with the financing challenge presented by returning money to customers in AMP7. However, even if the company hoarded this cash, it would have no impact on future ratios under Ofwat's approach as illustrated in the very simple example below:

Impact of 5% outperformance	Annual £m	Total AMP6
Totex allowance	550.0	2,750.0
Actual spend	523.0	2,612.5
Saving	27.5	137.5
Opex savings: (£27.5m saving x 60% assumed opex = £16.5m)	16.5	82.5
Interest saving @2.6%	0.4	2.1

Impact of 5% outperformance	Annual £m	Total AMP6
Additional tax: (£16.5m opex + £0.9m interest) x 20%	-3.4	-16.9
Total retained		67.7
RCV (12/13 prices as at 2019/20)		7,500
Gearing impact (if all hoarded)		-0.9%
Closing gearing (assuming prior position = 62.5%)		61.6%

Because Ofwat adopts a notional capital structure in price setting calculations, company actions during AMP6 will have minimal impact on its funding settlement during AMP7. If the company deliberately uses the cash saving to reduce its gearing below the level in Ofwat's assumed structure, only the interest saving would have a positive impact on future cashflows – and this would be minimal (as seen above).

AMP7 – Ofwat treatment	Opening	Cashflow
Opening gearing assumption	62.50%	
Opening net debt	4,688	
Change in tax allowance		Nil
Change in interest assumption		Nil
Sharing of totex outperformance: (£16.5m x 50% sharing ratio)		-8.3
Gross up for tax: £8.3m / (1-20%)		-2.1
Company tax saving (due to lower revenue)		2.1
Net cashflow impact		-8.3
Impact on FFO / Debt (notional structure)		-0.18%
Impact of interest saving (actual structure)		+0.00%

This method has not been reconsidered since PR04, considering the scale of other changes in the AMP6 framework we believe it is timely to review alternative approaches as we don't think that the two-stage approach is relevant any more. We note that other regulators do not look at financeability before incentives are applied. At the very least, we think that Ofwat might wish to consider whether it is reasonable to treat all legacy in the same way (as far as financeability is concerned).

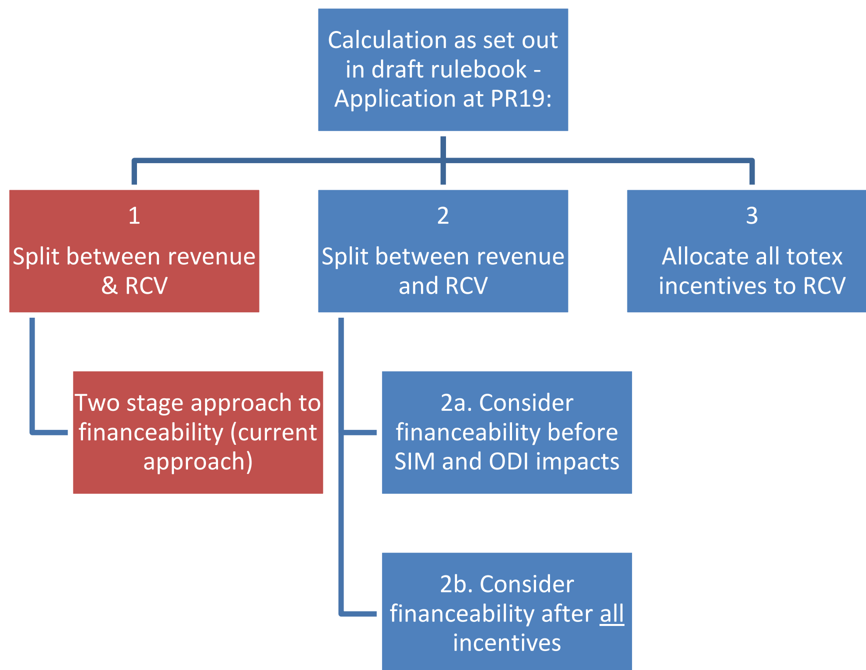
In addition, we think that the current two-stage approach will become increasingly complex to implement in future. If there is further disaggregation of the value chain, then there will be multiple controls within wholesale. At PR14 Ofwat only looked at credit metrics at the appointee level. But if these new controls are set to different time-scales, Ofwat will need to start looking at the financeability of each control independently. Any new entrant looking to participate in a section of this chain will argue that the prices available need to provide reasonable returns to an equally efficient operator.

We note that Ofwat does not look at financeability after *all* incentives. If any incentive takes effect through the RCV, the impact will be part of the financials at the point that Ofwat considers financeability.

So, for example:

- Serviceability penalties – which were negative adjustments to the RCV arising from poor performance - were **included** at the point that Ofwat considered financeability; but
- Revenue correction – which was a true-up, being the operation of a revenue cap – was **excluded** from financeability considerations.

We think there are two ways in which Ofwat could avoid future inconsistency.



We consider the merits of these options in the table below.

Option	Advantages	Disadvantages
1. Revenue element, 2 stage approach to financeability	✓ Revenue element means customers do not wait too long to receive benefit of any savings	× Most complex approach × Does not distinguish between incentives and true-ups × Will make efficient companies unfinanceable × Perverse incentive to reinvest all efficiencies
2a. Consider financeability before SIM and ODI impacts	✓ Customers do not wait to benefit from savings ✓ Avoids perverse incentives ✓ Recognises difference between incentives and true-ups	× No saving in complexity over method 1 × Perverse incentive to reinvest some efficiencies to avoid SIM and ODI penalties

2b. Revenue element, consider financeability after all incentives	✓ Revenue element means customers do not wait too long to receive benefit of any savings ✓ Simple approach ✓ In line with other regulators ✓ Avoids perverse incentives	× More complex than RCV-only
3. Adjust all incentives (or all totex incentives) through RCV alone	✓ Most simple approach ✓ Easy to combine with move to multiple price controls ✓ RCV changes are implemented before financeability considerations	× Customers have to wait longer to receive the benefit of efficiency. × Complexity of the 2-stage approach would remain if this only applied to totex incentives.

Adjusting for all totex incentives through the RCV would neatly side-step the perverse incentive to avoid efficiency – but only because Ofwat's existing policy on financeability is not applied consistently (as discussed above). It would be simple to resolve – but it would mean that customers would not see a huge saving from company efficiency in the short term.

Our preferred approach would be option 2b. This balances the interests of customers and company financing because the impact of sharing efficiencies would be taken into account. Option 2a represents an improvement over the current approach, but since it still involves a 2-stage approach to considering financeability it remains a complex approach.

In our view, Ofwat needs to look at financing after the impact of all incentives. These are the cashflows that companies will actually experience. With more and stronger incentives, we do not think it is reasonable to ignore these effects, or the consequences that they may have on company decision making.

Section A4.3 WRFIM

Ofwat position:

- Calculation based on November RPI (but this is not defined in Rulebook)
- WRFIM formula and spreadsheet still uses with two year lag although Rulebook specifies no changes until PR19
- In-period ODIs are excluded from the WRFIM
- No tax adjustment is included at PR19
- Blind year adjustment is included at PR19

SVT position:

- Agree with use of November RPI to judge difference between assumed and actual revenue.
- Rulebook and spreadsheet need to recognise that automatic correction of revenues within AMP6 is not allowed and WRFIM formula defined in line with this.
- Agree that in period ODIs should not affect the WRFIM.
- Disagree with position on tax, which we think could lead to customers paying twice for taxation (the outcome Ofwat is seeking to avoid).
- Do not see a need for a blind year adjustment at PR19 – companies very unlikely to forecast revenues that do not match the allowance in 2019/20

As we discussed under the key issues section, we think that there is a need to define the way that the Revenue Requirement is indexed for comparison with actual revenue.

The consultation on the WRFIM described how the penalty rate ought to apply and envisages that where a company has over or under-recovered, a penalty interest rate of 3% applies to the excess. It also sets out a formula which effectively indexes the adjustment for two years' RPI:

$$\mathbf{RFIM_t} = -\left\{(\mathbf{RR_{t-2}} - AR_{t-2}) \times \left[1 + \left(\frac{I + PR}{100}\right)\right] \times \left[1 + \left(\frac{I}{100}\right)\right]\right\} \times (1 + RPI_{t-1}) \times (1 + RPI_t)$$

Although the rulebook gives a definition for $\mathbf{RR_{t-2}}$, it does not explain how it is calculated.

We think this should be:

RR_{t-2} = RR in base year (November 12) prices inflated using actual November RPI_{t-3}

We can see that Ofwat's spreadsheet is intended to work in this way, and to test our understanding we have populated it using the November 12 prices revenue requirement from the FD. This appeared to work correctly.

All that remains is to define the terms and the spreadsheet in line with the way that the WRFIM will actually work in AMP6.

Firstly, the formula, the model and the examples in the draft rule book are still set up as if corrections to allowed revenue are applied after a two year lag. The consultation expressly states that revenue correction will not occur until PR19.

Companies' allowed revenues **will not** be adjusted for WRFIM in AMP6. But in the model and the example, a company that complied with its original revenue allowance (as it must) would be subject to an increasing penalty from year 3 onwards for not taking account of prior year corrections. We assume that Ofwat does not intend for this to be the case.

Companies might wish to abate K in order to manage any adjustments that would be required at PR19 (for example, to return money to customers earlier than AMP7). We think this could be agreed voluntarily with Ofwat. But our understanding is that the automatic correction coded in the spreadsheet does not exist.

Secondly, we think it might be possible for Ofwat to correct for the final year of AMP6 (19/20) in the way that was originally envisaged, provided the Licence is amended before PR19. If this can be done, we think a single correction for the blind year in 21/20 would be preferable to an estimate for the blind year being included in PR19. We would have thought that all companies will forecast revenues that deliver an adjustment of zero, as their charges will be designed to recover the revenue allowed.

Thirdly, there appear to be a number of errors in the indexation. The spreadsheet includes an RPI sheet which shows the **cumulative** increase from 12/13 prices. In the computation of the WRFIM penalties, this is treated as if it is an **annual** increase.

We have annotated these issues on a modified WRFIM spreadsheet which is included as an appendix to this consultation response. We've added an extra tab which lays out the way in which we think the correction ought to work, given that correction after two years is not available:

- Calculate the difference between **actual** revenue and $\mathbf{RR_{t-2}}$ as per the original workings.
- Calculate the present value of this difference in 2020/21 using the vanilla WACC for PR14.
- Uplift to base year prices for the following review.
- Convert the amount to an annuity and spread it over AMP7, using the vanilla WACC for PR19. This provides the true-up.
- Repeat the process applying the penalty interest rate in any years where actual revenue was outside of the tolerance limit. The difference is the incentive (penalty) for poor forecasting.

We think it is important to distinguish between the element of the WRFIM that is actually an incentive for forecasting accuracy, and which is not. Corrections within the 2% threshold are just part of the revenue control, a true-up to the amount of revenue to which the company was entitled. It has no incentive properties.

A4.3.1 Tax treatment of WRFIM

The preferred approach in the consultation document is that the WRFIM should not be adjusted for tax. We are not sure that this is the correct approach.

The key question is not the tax allowed within the current revenue cap – it is how the WRFIM amounts will be included within the financial model at PR19.

Approach	Consequence	Correct treatment
Added to post-tax revenue allowance (PR14 approach)	Financial model allows tax on the addition. Customers pay for this tax.	Adjust input value for tax.
Added to turnover (PR09 approach)	No extra tax allowed. Companies bear the tax consequences.	Do not adjust input value for tax.

The concern that Ofwat identify – the potential for a double taxation allowance – is well-founded. But assuming the PR14 method continues to be used (and we think it should, because it is simpler than the macro-driven approach used to add on incentives at PR09), then **the preferred option would have the opposite of the intended consequence**.

Consider the following example:

£m	AMP6	AMP7	
Allowed revenue	1,000	1,000	Allowed revenue before correction
Actual revenue	980		
Under-collected	(20)	20	Correction in post tax revenue
	-	5	Tax allowance in revenue requirement
Company revenue loss	(20)	25	Customer pays (customer loss = £5m)
		1,025	Net value of allowance
Tax saving	(4)	(5)	Tax cost (25 x 20%)
Net loss to company	(16)	20	Net gain to company = £4m

This is why we believe that the correction **should** be adjusted for tax. In the example above, the correct approach would be to include £16m within the revenue requirement (the company's net loss after tax). The tax calculation in Ofwat's model would restore this to £20m, so the amount paid by customers in AMP7 would be symmetrical with the under-recovery in AMP6.

We understand that this position is complicated by the fact that some companies do not pay current tax. The key thing is to generate the correct outcome for customers in AMP7 – in the example above, that customers should only pay £20m for the under-recovery. We therefore propose a simple rule in Ofwat's modelling:

- If the company would receive a tax allowance on the true-up in AMP7 then the correction should be adjusted for tax;
- Otherwise, the gross amount should be included in the revenue requirement.

We think this should be relatively easy to assess based upon Ofwat's modelling. It could be based on the notional company structure (but with interest payments based on the company's actual level of gearing), which would avoid the need to look at effective rates of tax in companies' historical accounts.

A4.3.1 Adjustment for property numbers

The old AMP5 Revenue Correction Mechanism included an "Efficient Billing Incentive" which varied the revenue cap depending on the number of properties served. The Rule Book is silent on this topic and we infer that it has been dropped. We are comfortable with that position. We think that the retail controls should provide adequate compensation for cost variation driven by variations in the number of property served, which (from the evidence we submitted in PR14) is driven more by the level of house building than by company action.

A4.3.2 Revenue for ODI performance

We agree with Ofwat's preferred option, that the WRFIM should be adjusted to take account of ODI revenue taken during AMP6. The alternative could involve penalising companies for taking account of performance in a timely fashion, which would be perverse.

A4.3.3 Adjustments to the wholesale control

Although the type of revenue cap envisaged in the WRFIM consultation has not been implemented, we might wish to voluntarily vary our charges within period in order to manage bill effects

We might, however, wish to voluntarily abate charges. Companies have often applied voluntary reductions in bills (or increased them at a lower rate than allowed) for a number of reasons:

- The most recent example of this was in the year preceding this price control, where several companies abated K in response to Johnson Cox's letter.
- Severn Trent abated K in AMP4 to return money to customers early – e.g. for supply demand schemes that were not required.

During AMP6, we might wish to abate K in order to:

- Reduce the size of any correction due in AMP7
- Claim less than the full allowance for ODI performance if we felt that this was not justified by the trend of performance (or reduce charges earlier than 2017/18 to reflect targets missed)

We think that it would be reasonable for us, in consultation with Ofwat, to adjust allowed wholesale revenues for the purpose of calculating the WRFIM if we were deliberately trying to manage past collection – for example, to avoid more significant increases in AMP7 bills.

Although the consultation does envisage that there can be discussions between Ofwat and the company around the reasons for any variation, we think it would be helpful to give some

indication about the circumstances in which an adjustment might be made – and to include some scope for this within the spreadsheet model.

Section A4.4 Water trading mechanism

Ofwat position:

- Import incentive will be an extra 5% of the costs of water, subject to a cap of 0.1% of importer's water service turnover.
- Reward allowed at PR19 subject to compliance with Trading and Procurement Codes, which Ofwat must approve and may review on an annual basis.
- Export payment at PR19 of 50% of the full discounted economic profit for the forecast life of the export, capped at 100% of the economic profit for the years the export operates in 2015-20. Any excess above the cap rolled forward to future control periods.
- Recognise inflation, the time value of money and provide a tax adjustment.

SVT position

- Companies need certainty in order to make investments. If they do not know whether a trade will qualify for the incentive until PR19, any investment to facilitate a water trade may be discouraged.
- Ofwat needs to be clear about the way in which the economic profit will be calculated, and how it interacts with totex incentives.
- We understand there may be concerns about bringing the lifetime profits from a trade into a single control, which could cause a significant effect. But we think limiting the amount allowed in AMP7 to half of economic profit earned up to 2025 would provide customers with adequate protection.

A4.4.1 Qualification for the incentive

Ofwat's appendix on Trading and Procurement Codes envisages that in order to qualify for trading incentives (import or export) the two companies must have a contractual agreement in place. The contract needs to be consistent with a Code that the importing company will need to produce itself. The code must be published and Ofwat will provide approval after six weeks.

All of these steps appear reasonable. The only potential issue is that Ofwat reserves the right to review codes on an annual basis. It would be helpful if Ofwat could confirm that any recommendations it makes as part of these reviews will not affect trades that have already been agreed. It would not be reasonable for a company to have signed a contract under a code which it believed compliant, and then be informed that the Code did not meet a standard that Ofwat subsequently implemented.

The wording in the Rule Book is not helpful in this regard as it states that Ofwat will decide on the awards retrospectively. We think Ofwat should clarify that provided a contract is made in line with an approved code, it will qualify.

A4.4.2 Calculation of economic profit

Ofwat's final methodology states that a company will be allowed to retain 50% of the "economic profit" from a qualifying export, which it defines as the profit over and above the

allowed cost of capital. Given the interaction between incentive mechanisms at PR14, we think a tighter definition would he helpful.

We believe this means:

- Revenue received from the importing company; less
- Company share of totex spent on the export; less
- The return on the capitalised element of that totex in the RCV.

Our reasoning is that the exporting company will incur some additional totex in order to make the trade. All else being equal, this reduces the totex incentive the company earns (the c50% through the sharing rate). At PR19 a portion of the additional totex will be capitalised within the RCV. The "normal" profit on the capital element would be equal to the company share of the extra "capital" multiplied by the WACC.

The case for the import incentive is rather more complicated, because the importing company needs to earn an additional 5% incentive on savings that arise from the trade – and only the trade.

A4.4.3 Capping of reward at PR19

Water resources involve long term planning and therefore we support Ofwat's intention to allow 50% of the *lifetime* profits from the trade to be retained.

We recognise that including 50% of the lifetime profits within a single control period could result in significant bill impacts for customers and therefore it is reasonable to apply a cap in AMP7, provided the additional amounts are rolled over to future periods. However, we think limiting this to 100% of the economic profit earned in AMP6 does not appear proportionate. We think the cap ought to be calculated as 50% of profit in AMP6 and AMP7.

All else equal, bulk supply income that qualifies will be deducted from the revenue requirement at AMP7 (Ofwat's financial model treats qualifying bulk supplies the same as all "other income"). This means that customers of the exporting company will receive the full benefit of water trades, less any incentive allowed.

In the following example, a company has an export that delivers £10m revenue and costs £5m totex per year. The trade is relatively short-term, running to 2025. If the "economic profit" is calculated in the way we have set out above, then the additional profit in excess of the return on capital it is around £7.5m. But since it only starts in the final year of AMP6, the amount that can be claimed in AMP7 is limited to half of 1 year's profit. This works out to around £1.7m per annum.

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			19/20	20/21
Income from bulk supply	10.000	100%	10.000	10.000
Totex cost £5m @50% sharing rate	(5.000)	50%	(2.500)	(2.500)
Economic profit			7.500	7.500
Deemed capex (1- PAYG 60%) x £2.5m	40%	1.000		
Implied closing RCV			1.000	2.000
Normal profit @3.6% WACC		3.6%	(0.018)	(0.054)
Additional profit			7.482	7.446
NPV of additional profit	76.152			
Total incentive allowed (50%)	38.076			
Cap for AMP7	7.482			
Carried over to AMP8	30.594			
Incentive allowed in AMP7				1.662
Deduction from customer bills due to bulk supply				(10.000)
Net wholesale charges for exporting company				(8.338)

Given that the income relating to the trade is deducted from the exporting company's bills, the impact on the company's customers is very positive. We think any concern about large bill increases for the exporter's customers are probably unfounded and that it would be reasonable to cap the allowance in AMP7 at 50% of economic profit in AMP6 and AMP7.

We have attached some simple workings, but it would be helpful if Ofwat could clarify how it intends to calculate the additional economic profit.

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Section A4.5 PR09 reconciliation mechanisms

Ofwat position:

Adjustment for opening PR19 RCV due to PR09 CIS adjustment (see section B of this document)

Adjustment for COPI when accurate data becomes available

Include a materiality threshold for blind year adjustment.

PR19 adjustments will be made for actual RPI, tax and the time value of money

SVT position:

In relation to the legacy PR09 CIS adjustment see section B of this document.

We disagree that a materiality threshold is necessary and feel in reality it would add complexity

We welcome Ofwat's signalled intent to agree legacy adjustments early in AMP6 rather then waiting until PR19. Further clarification of the timing of this process with the final rulebook will be welcomed. Ideally we would like to agree the true up for the 2014/15 blind year including any further adjustments for logging or shortfalls with the submission of the annual return so we can report the impact in the shadow RCV.

The consultation proposes applying a triviality test for variation in 2014/15 expenditure. We do not see the need for a triviality limit for legacy adjustments and we do not think it offers any benefits in terms of simplification.

The concept of a triviality threshold is reasonable when applied to relevant changes for an Interim Determination (IDoK) or the old logging up process. It helps to keep the number of changes that need to be considered down to a manageable level. In an IDoK it can potentially help with the problem of information asymmetry: there are a great many changes that will have an effect on company costs or revenues between reviews; companies are better placed to know of these and are more likely to report adverse impacts than favourable changes.

These factors do not apply to legacy adjustments. There are a limited number of mechanisms that can adjust future revenues or the RCV and they have all been laid out by Ofwat in its Final Determination. Once the process for calculating the impact is confirmed, recalculating them is mechanical.

If a triviality threshold was applied, the same calculations would still have to be performed to determine if they were trivial. Therefore we think that a triviality limit would, if anything, make the process more complicated.

Section A4.6 Retail reconciliation

Ofwat position:

- Include a 'wash up' between allowed and outturn revenues in PR19
- Do not adjust for the time value of money
- Do not adjust for taxation

SVT position:

- We agree that a 'wash up' in PR19 is required, but that this should go further than the impact of customer numbers.
-

In the WRFIM consultation, Ofwat considered the need for a forecasting incentive or correction for retail. There is no clear conclusion as to whether a "wash-up" for retail at PR19 is required.

We think that a "wash-up" for retail at PR19 is required because:

The average revenue per customer approach means that there is automatic compensation for the number of properties served, but:

- Retail charges have actually been applied through a mixture of **fixed and variable** charges
- Discount schemes (**WaterSure** and **Social Tariffs**) are balanced through the household retail control (meaning that most customers pay more than the average retail allowance so that these customers can pay less)
- If the **volume multipliers** are different to our expectations, this will lead to a difference in the revenue collected

Charges for retail numbers are based on central estimates, consistent with the requirements for wholesale. It is very likely that we will either over or under collect relative to the allowed average revenue per customer.

We illustrate our position by using a worked example, below.

Retail controls – how a company might exceed the household retail control

Social Tariff	Expected	Actual	Variance
Number of customers receiving (000)	12	12	Nil
Number paying (000)	3,137	3,157	20 (0.6%)
Subsidy per customer	£153.30	£153.30	Nil
Per customer paying	£0.57	£0.57	Nil
Amount paid (000)	£1,781	£1,792	£11

In this example the company could over-collect simply because of a higher than expected level of new connections (outside of company control). This would be exacerbated if fewer customers qualify for the discount, or the required amount (as assessed by the CAB) is lower than anticipated

This is why we consider that some form of correction will be required at PR19. Our aim is to comply with the controls that we have been set, but there will always be differences between our forecast and reality; we think it would be sensible to anticipate this and set up a process to deal with these variances.

Part B: PR09 legacy CIS model reconciliation

Section B1 Overview

We disagree with Ofwat's recommendation to adjust the RCV at PR19 to remove the amount remaining in the RCV from the use of different indexation assumptions (section 4.2 of the PR14 rulebook consultation).

We do not consider that the proposed adjustment to the RCV via the CIS mechanism is part of the PR14 Rulebook. The issue is not a clarification of a factor in our PR14 Final Determination (FD) but a material change to the FD we have accepted. Therefore we have set this issue out separately from our consultation response. We note that Ofwat briefly referred to this issue within the FD but this does not turn it into a PR14 issue.

We view that any change to the future RCV from the values agreed in the PR14 FD to be a form of retrospective regulation. We disagree with Ofwat's position that it is in the best interests of customers to make this adjustment as any perceived benefit could be undermined by the loss of confidence in the sector and potential future investor reaction.

We have outlined our specific concerns in Section 2 under the following headings;

- Procedural concerns.
- Technical issues.
- Investor confidence and interest of customers.
- Implications for reporting the shadow RCV.

Section B2 Concerns

B2.1 Procedural concerns

We are concerned that the process followed meant the scale of the potential adjustment was not made available at the time of the FD. Ofwat continuously assured the industry (including at the (Draft Determination) that its calculation of the RCV true-up was correct. This position only changed at the FD where it included a paragraph saying it would review whether the RCV calculation was correct.

The potential value of this adjustment was not included in the FD. When Ofwat do refer to the issue in policy chapter A4, they state that adjusting for the issue "*may have resulted in a slightly different 2015 opening RCV*". Ofwat's subsequent consultation values the adjustment at £1.2 billion across the industry. In our case this proposed adjustment will be £131 million, 4.4% of regulatory equity (assuming notional gearing of 62.5%). We consider that to refer to an industry adjustment of £1.2 billion as '*slightly different*' as misleading.

We understand the full impact of the proposal was available to Ofwat's Board prior to the publication of the FD. We feel Ofwat should have included the impact of the adjustment with

the FD. Publishing draft numbers would have meant companies could have considered this when deciding on whether or not to accept the FD. As the consultation has been published after the deadline to request a referral to the CMA it removes companies' ability to challenge the decision via the CMA.

We also feel the consultation also fails to fully consider the impact of changes on company financeability. The consultation does not consider that there will be immediate effects given that this change to RCVs will be publically announced following consultation. For example, companies will now be required to report shadow RCVs in their regulatory accounts. The consultation does not discuss how the future midnight adjustment to RCV will be disclosed and the impact that this could have on company financing before PR19.

Accepting a price review is about taking all the elements in the round, irrespective of whether everything has been calculated correctly. Once the FD has been accepted, the expectation is that the deal is final. We disagreed with many of the legacy calculations in the FD and made several representations about their inconsistency. But, having accepted the FD, we were obliged to accept the outcome of many aspects where we disagreed with either the calculation or the policy.

We believe that this same 'acceptance in the round' should apply to Ofwat as well. Despite its wording to the contrary we believe this proposal is a retrospective adjustment. It is adjusting at PR19 something which happened in PR09. The fact that the adjustment doesn't crystallise until PR19 in the proposal is irrelevant.

We are concerned by the precedent this creates for Ofwat to propose material changes to a Final Determination by referring to a future consultation in the FD document. This means the Final Determination is not final so it becomes unclear what deal has actually being agreed.

B2.3 Technical Issues

Ofwat published PWC's report providing a technical review of legacy adjustments with the final determination documents ("Reconciling 2010-15 Performance: Technical Review"). PWC's report identified 21 issues and classified each of the issues into one of three categories;

- A=Inconsistency between policy and the modelled mechanism,
- B=Lack of clarity and detail in the policy,
- C=Representations we do not believe are accurate.

Of the 21 issues identified PWC's report identified 18 errors or inconsistencies in Ofwat's approach (category A or B). The indexation issue on the CIS RCV adjustment is 1 of 16 issues that PWC has identified as a category B issue. The other category B issues relate to indexation issues with the 2009-10 capex in the RCV and discount rates/NPV on CIS, RCM and land sales. We have estimated the financial impact of the issues identified in the PWC report; these can be seen in the table in annexe 1. Of the 16 category B issues we estimate

if adjusted 5 would be favourable to STW, 3 would be marginally adverse to STW and the CIS indexation would be significantly adverse for STW (more detail is provided in Annexe 1)

Ofwat are selectively applying an adjustment to the CIS (which moves against companies) but no adjustment in other areas. If Ofwat insist on applying retrospective regulation (which to be clear we do not support), they should do so consistently across all of the other factors as well.

B2.3 Investor confidence and interests of customers

Ideally, all rules for PR14 should have been laid out before the Final Determination. This consultation could represent a step forward compared to the uncertainty over PR09 mechanisms, but that would be completely undermined by a retrospective change to rules which Ofwat had published before.

Confidence in the RCV and associated returns is a cornerstone of the water sector. Ofwat risk undermining the confidence of investors. This could result in an increase in required returns (and hence the WACC) due to the erosion of that certainty and stability.

Credit rating agencies rate the UK regulatory framework at the highest level due to its predictable nature, where the regulatory contract is agreed ex ante. This is an important factor in the overall assessment of risk. If the agencies saw this as a material change, they could consider reducing the weight they apply to regulation in the sector, which would potentially reduce the ratings for the whole sector. It is uncertain how Moody's and S&P would view this change.

B2.4 Shadow RCV

Although we disagree with the adjustment to RCV via the CIS mechanism, should this stand, this would also need to be factored into the shadow RCV and there should be clear rules as to how this is done, and whether a 'Shadow RCV*' is reported which includes the impact, separately from the main shadow RCV.

As noted in Part A, AMP6 is the first time a shadow RCV will be published. Given the importance of this value to investors, we believe it is imperative that Ofwat address the issue of the RCV adjustment and how this is reported.

If included in the shadow RCV it will distort comparison to the published FD RCV values, which did not include this adjustment. If excluded it will not represent a true picture of the 'shadow RCV' as will not take these known changes into account.

One option could be to publish two separate shadow RCV values, one with and one without the CIS adjustment.

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Annexe 1: PWC legacy adjustment assessment

Estimated impact on STW	CATEGORY A Inconsistency between policy and the modelled mechanism	B Lack of clarity and detail in the policy
Number of issues by category	2	16 (INDEXATION - IRE is counted as 3 separate issues)
Source: PWC report on Reconciling 2010-15 Performance: Technical Review		
CAPITAL INCENTVE MECHANISM		
Ofwat calculated impact **↓£130.9m**		**INDEXATION** Issue on inconsistency in the application of indexation factors applied to capex within the true up calculations. The capex allowance used in the RCV adjustment is rebased using outturn RPI, whereas the capex allowance used in the financing cost adjustment is rebased using the RPI forecasts from the PR09 Final Decision, creating a mismatch between the two. The policy is not explicit on which indexation factors should be used but they appear to be inconsistent.
Part of this issue has been addressed during the FD with Ofwat switch to use the AMP5 post tax discount rate instead of the pre-tax discount rate. There is still an impact of **↓£2.4m** if Ofwat correct the NPV calculation issue of using the same PV in 2015 and 2016.	**NPV** The stated policy for revenue adjustments earned on performance in AMP5 was to ensure that the incentive adjustments received in AMP6 were NPV neutral. The CIS model uses a pre-tax WACC to calculate the NPV effect in AMP5 but for unwinding into AMP6 uses a post-tax WACC to calculate the NPV effect. PWC argue that whilst the policy does not set out the rationale for the use of the two different WACC's, the approach anyhow would not give a NPV neutral result as the WACC in AMP5 and AMP6 would be different. PWC state that however, they would expect the WACC used in AMP5 and AMP6 to be on a consistent basis.	**NPV** The stated policy on CIS is that it should be NPV neutral but the policy does not explicitly detail how this can be achieved. PWC note that there are mechanisms in the CIS model to do this but there are also other ways to achieve it.
Switching to cash flows being mid year would result in an impact of **↑£0.5m.**		**NPV** There is no explicit detail in the policy that the cash flows used in the NPV calculations all occur on the last day of each year.
REVENUE CORRECTION MECHANISM		
If we correct for the inconsistency in rates used and use the Vanilla WACC then the net impact would be **↑ £0.3m**		**DISCOUNT RATE** The RCM policy states that the PR09 or/and PR14 discount rates should be used but is not clear if they should be pre or post tax. Both of them are used at difference points in the model but it is not directly contrary to policy.
Switching to cash flows being mid year would result in an immaterial impact of **↑£0.02m.**		**DISCOUNT RATE** The 'PR09/31 Revenue correction mechanism – technical details, Appendix E' prescribes the usage of the "pmt" excel function for the calculation of annualised payments of the revenue true up for the next five years. By default this formulae discounts at the end of the period. Discounting to the end of the period is not explicitly described in the policy.
Restating EBI and BB to post tax would have an impact of **↑£7.9m**		**TAX** There is some inconsistency in the treatment of billing and back billing incentives which are pre-tax whilst the revenue correction element is post-tax. However, PWC argue that it is in line with legacy policy and guidance and the nature of the inconsistent treatment was explained in the legacy workshop on reconciling 2010-15 performance (workshop slides p. 33-37) dated 9 April 2014.
OPEX INCENTIVE ALLOWANCE		
		SERVICEABILITY SHORTFALLS The OIA model includes the adjustment "Baseline view of one-sided adjustments to water/sewerage service total opex for shortfalls relating to serviceability" to the revised FD09 expectations. This adjustment is not covered in the policy.
		OVERLAP PROGRAMME The policy does not clearly state what items should be picked up from the overlap model for the OIA model calculations. The "Operating expenditure outperformance feeder model" description and "Setting price controls for 2015-20 – business planning expectations - A consultation" mentions using inputs from the overlap programme but is not explicit to which.
RCV ADJUSTMENT Workings for RCV adjustment here		
↑£7.59m		**INDEXATION - IRE*** The indexation treatment for IRE in PR09 midnight adjustment is different to other capital expenditure. The treatment is summarised as follows: • Capex: (Actual * (07 RPI ÷ 09 RPI)) – (Expected * 09 COPI * change in notified index) • IRE: (Actual * (07 RPI ÷ 09 RPI)) – (Expected) b) PWC note that there is an exclusion of the notified index and COPI from the expected IRE calculation, but believe that the inputs for the RPI element of the calculation is consistent for both Capex and IRE. c) There is no policy setting out how 2009-10 outperformance adjustment (IRE) is calculated.
↓£2.6m as a result of switching to the PR09 discount rate		**DISCOUNT RATES - LAND SALES** The discounting methodology applied to the land sales adjustment is inconsistent with the basis of indexation used throughout the rest of the model.
		DISCOUNT RATES - LAND SALES There is no prescriptive guidance in the policy stating how Land sales will be rebased, however the rate applied appears to be the pre-tax WACC rather than the post-tax WACC used elsewhere.
		INDEXATION ON CAPEX IN 2009-10 Expected capex which is on the 2002-03 price level has been inflated by COPI to 2007-08 price level and inflated by NI to 2009-10. This creates inconsistent indexation throughout period of 2002-03 to 2009-10. There is no policy explicitly covering application of this indexation.
Impact for correcting indexation on water discretionary expenditure would be **↓ £0.4m**		**INDEXATION ON DISCRETIONARY EXPENDITURE AND VIREMENT** There is no rebasing of discretionary capex spend in 2009-10 and virement in the model. For discretionary capex spend this value is subjected to the Notified Index which is an inconsistency in the application of COPI.
	DISCRETIONARY EXPENDITURE Discretionary spend in 2009-10 is double counted in the calculation of the Capex cap (Inputs row 18-20).	
		INDEXATION The opening RCV for 1 April 2015 is produced by the model in an average year price. If the closing RCV from the previous price review which comes from the fountain inputs is based on year-end RPI, it would be expected that the closing RCV values would also be rebased to year-end RPI. The rebasing method is not explicitly stated in the policy but they understand having inputs in year average prices for the PR14 model is in line with the requirements of the modelling inputs.
		* PWC has categorised this issue as 3 separate issues. For ease, given the separate issues are interlinked to the same adjustment the issue has been presented as one above.